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No. 91-____

Supreme Court, U.S.
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IN THE

Supreme Court of the United States

OCTOBER TERM, 1991

DELTA HOLDINGS, INC.,

Petitioner,

—against—

NATIONAL DISTILLERS AND CHEMICAL CORPORATION,

Respondent.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

PETITION FOR WRIT OF CERTIORARI

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QUESTIONS PRESENTED

1. Is it an actionable misrepresentation under the federal securities laws for a seller of securities to present on a balance sheet a reserve liability that is materially understated based on information available at the time; or, as the court of appeals held in conflict with other circuits, are reserve liabilities—which are often the most significant liability items on financial statements of insurance and banking institutions—effectively exempt from accurate reporting requirements because reserve calculations involve the estimation of future losses?

2. Is the objective standard of materiality under the federal securities laws—*i.e.*, whether a reasonable investor would have considered the information significant in making an investment decision—inapplicable as a matter of law when the investor has retained professional advisors?

3. On an appeal from a bench trial, may a United States court of appeals reverse a district court by making its own findings of fact and substituting them for findings of the district court which it does not determine were clearly erroneous?

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1991

No. 91-_____

DELTA HOLDINGS, INC.,

Petitioner,[1]

—against—

NATIONAL DISTILLERS AND CHEMICAL CORPORATION,

Respondent.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

PETITION FOR WRIT OF CERTIORARI

Delta Holdings, Inc. hereby petitions for a writ of certiorari to review the judgment of the United States Court of Appeals for the Second Circuit in this case, which raises issues of profound importance respecting enforcement of the federal securities laws.

OPINIONS BELOW

The opinion of the court of appeals (App. at 1a-51a) is reported at 945 F.2d 1226. The opinion of the district court

1 Petitioner has no parent corporation, subsidiaries or affiliates.

(App. at 53a-71a) is reported at [1990 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 95,227.

JURISDICTION

The judgment of the court of appeals was entered on October 1, 1991. A timely petition for rehearing and a suggestion for rehearing *en banc* were denied on November 27, 1991 (App. at 52a). This Court's jurisdiction is invoked under 28 U.S.C. § 1254(1).

STATUTES AND RULES INVOLVED

Section 12(2) of the Securities Act of 1933, 15 U.S.C. § 77*l*(2), in pertinent part provides:

> "Any person who—
>
> (2) offers or sells a security . . . by means of a prospectus or oral communication, which includes an untrue statement of a material fact or omits to state a material fact necessary in order to make the statements, in the light of the circumstances under which they were made, not misleading (the purchaser not knowing of such untruth or omission), and who shall not sustain the burden of proof that he did not know, and in the exercise of reasonable care could not have known, of such untruth or omission,
>
> shall be liable to the person purchasing such security from him, who may sue either . . . to recover the consideration paid for such security with interest thereon, . . . upon the tender of such security, or for damages if he no longer owns the security."

Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78*j*(b), in pertinent part provides:

> "It shall be unlawful for any person, directly or indirectly . . .

(b) To use or employ, in connection with the purchase or sale of any security . . . any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors."

Rule 10b-5, 17 C.F.R. § 240.10b-5, provides:

"It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,

(a) To employ any device, scheme, or artifice to defraud,

(b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,

in connection with the purchase or sale of any security."

Rule 52(a) of the Federal Rules of Civil Procedure in pertinent part provides:

"Findings of fact, whether based on oral or documentary evidence, shall not be set aside unless clearly erroneous, and due regard shall be given to the opportunity of the trial court to judge of the credibility of the witnesses."

STATEMENT OF THE CASE

This action under Section 12(2) of the Securities Act of 1933 and Section 10(b) of the Securities Exchange Act of 1934 arises from the purchase by petitioner Delta Holdings, Inc. ("Delta") of all the stock of Elkhorn Re Insurance Company ("Elkhorn") from respondent on September 30, 1983. The purchase price was $18 million, the amount that respondent expressly represented was Elkhorn's net worth. As both the district court and the court of appeals agreed, that representation was false. Elkhorn's net worth was *not* $18 million; the company was insolvent.

Respondent's overstatement of Elkhorn's net worth stemmed from a misrepresentation on its balance sheet of a liability item for loss reserves; *i.e.*, the company's reserves for its liability, as an insurer, to pay losses incurred by its insurance customers. Loss reserves are usually the largest liability item on an insurance company's balance sheet. For that reason, in the words of the district court, "the importance of these loss reserves is profound . . . ." App. at 56a. The court of appeals agreed that the adequacy of Elkhorn's loss reserves was one of the "most important aspects of Elkhorn's financial health." App. at 19a.

The district court found—and the Second Circuit concurred—that Elkhorn's balance sheet "grossly understated" its loss reserve liability. App. at 60a. In fact, as the court of appeals observed, a proper calculation "might have revealed a loss reserve deficiency of as much as $108 million as of the date that Elkhorn's books represented a net worth of $18 million." App. at 22a. A $108 million reserve deficiency would reduce Elkhorn's net worth essentially dollar for dollar, meaning that Elkhorn was *insolvent* by up to $90 million when Delta purchased its stock.

The District Court's Opinion

Following a bench trial, the district court concluded that respondent had "utterly failed to live up to its duty under the

federal securities laws." App. at 69a. The court found that respondent "falsely represented . . . that Elkhorn's June 30 and September 30, 1983 balance sheets [showing a net worth of $18 million] were a fair representation of Elkhorn's financial condition on those dates . . . ," that respondent "knew the representations were false," that the misrepresentations were "obviously material" and that "Delta understandably relied on [respondent's] false representations." App. at 65a. Those ultimate findings were premised on detailed findings including the following:

1. In October, 1981, respondent engaged the Tillinghast actuarial firm to study Elkhorn's loss reserves because respondent realized that Elkhorn's method of calculating loss reserve liability was "not a good system." App. at 61a.

2. Tillinghast proposed that, as part of its study, it would calculate Elkhorn's required loss reserves. Respondent rejected this proposal because it knew that such a calculation "would record that Elkhorn's loss reserves were seriously understated." App. at 61a.

3. Tillinghast nevertheless prepared and delivered to respondent two reports which, "[t]aken together, . . . concluded that the Elkhorn loss reserves were some $21 million understated at the end of 1981," "a sum that 'was just about Elkhorn's net worth . . . .' " App. at 62a-63a. Tillinghast also made specific recommendations to rectify the understatement of Elkhorn's loss reserve liability, which respondent ignored. App. at 62a.

4. Respondent concealed the existence of the Tillinghast reports from its own auditors, Price Waterhouse. App. at 62a.

5. Respondent concealed the existence of the Tillinghast reports from Delta and from Delta's professional advisors in the transaction, affirmatively misrepresenting to Delta that no such study had been done. App. at 64a. "The weight of the evidence surrounding all aspects of the Tillinghast study and reports stamps Norton [Elkhorn's President and an offi-

cer of respondent] as someone who is not to be believed on the subject and who sought to hide from all outsiders the contents of the Tillinghast Reports and the fact that a study was performed." App. at 64a.[2]

6. Respondent "knew that Elkhorn was nearly insolvent at the end of 1981," the effective date of the Tillinghast reports, and "top executives of [respondent] knew very well that Elkhorn's business was going sour from 1980 through June 1983." App. at 65a, 63a. Thus, respondent knew at the time of sale in 1983 that the financial condition of Elkhorn had deteriorated from its already insolvent condition in 1981.

7. Elkhorn's insolvency at the end of 1981 "was obviously material and was not disclosed to Delta before the purchase"; and "Delta understandably relied on [respondent's] false representations." App. at 65a.

Accordingly, the court entered judgment in favor of Delta on its securities law claims.[3]

The Court of Appeals Opinion

The court of appeals did not dispute the district court's findings that respondent's representations as to Elkhorn's financial condition were false, material and relied upon by Delta. Indeed, the Second Circuit:

— Agreed with "the district court's finding, based on the testimony of Delta's expert witnesses, that Elkhorn was insolvent as of June 30, 1983 and that this insolvency was due to the underestimation of loss reserves." App. at 44a.

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2 The district court also found that Norton continued to conceal the existence of the Tillinghast reports after the purchase, when he became the president of the acquired company. App. at 66a. The reports came to light only after Norton resigned; one was discovered in his office in late 1984 and the other in early 1985. App. at 66a.

3 The district court also entered judgment on Delta's breach of warranty and misrepresentation claims under state law.

— Agreed that the understatement of loss reserves in Elkhorn's June 30, 1983 balance sheet "could have been detected [by respondent] from information available as of that date." App. at 44a.

— Acknowledged that the "district court's findings concerning the concealment of the Tillinghast Reports are not clearly erroneous," App. at 33a, and did not dispute the district court's finding that the reports demonstrated an understatement of loss reserves by more than $20 million.[4]

— Did not disagree with the district court's finding that, contrary to respondent's representation, Elkhorn's June 30, 1983 balance sheet was not complete and accurate in all material respects and did not present fairly its financial position.

Nevertheless, the court of appeals reversed, as a matter of law, the district court's conclusion that respondent's misrepresentation of Elkhorn's financial condition violated the federal securities laws. While the court of appeals agreed with the district court that respondent's representations in Elkhorn's balance sheets were objectively false[5], the court of appeals held that because the misrepresentations involved an

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4 The Second Circuit also agreed that the district court was not clearly erroneous in finding that Elkhorn's President completed the worksheets in the first Tillinghast report and knew from that calculation that Elkhorn's loss reserve liability was understated by at least $10 million. App. at 15a.

5 The false representations included (a) that Elkhorn's books and records "accurately reflect[ed] the financial condition . . . of Elkhorn"; (b) that the June 30, 1983 balance sheet was "complete and accurate in all material respects"; and (c) that the balance sheet "present[ed] fairly the financial position of Elkhorn as at that date." The court of appeals discussed these representations in a section entitled, "The June 30, 1983 Balance Sheet: Breach of Warranty." App. at 43a-51a. Since the court did not elsewhere in its opinion overturn the district court's findings that these misrepresentations violated the federal securities laws, the court's discussion on this point plainly applies not only to Delta's breach of warranty claim, but to its claims under the federal securities laws as well.

estimation of future payments, they could not give rise to liability. App. at 44a.

The loss reserve liability, the Second Circuit explained, is not subject to precise quantification "like a debt with fixed payments of principal and interest. Informed guesswork is an accepted basis for determining such reserves, and Elkhorn's books were based on such guesswork." App. at 51a.[6] In other words, the court below concluded that a reserve liability, which reflects an estimate of future payments, is too "soft" a number on which to base a violation of the federal securities laws even when it is falsely stated.

The court of appeals' reached this conclusion notwithstanding its agreement with the trial court that respondent's understatement of Elkhorn's loss reserves "could have been detected [by respondent] from information available as of that date." App. at 44a. That key fact necessarily means that respondent did not satisfy its burden under § 12(2) of showing that "in the exercise of reasonable care [it] could not have known" of Elkhorn's insolvency. Thus, while acknowledging that respondent had failed to satisfy the statutory standard under § 12(2), the court of appeals proceeded to apply its *own* standard which precludes liability as a matter of law when a statement—such as a reserve liability—involves estimation and is based on "guesswork."

Similarly, under § 10(b), the court of appeals failed to measure respondent's conduct by the "recklessness" scienter standard adopted by virtually all other courts of appeals.

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6 In reaching this conclusion, the court of appeals rejected a finding that the district court never made. The district court did not state, as the court of appeals suggested, that respondent had "guarantee[d] . . . that loss reserve estimates on Elkhorn's books would prove in the future to be substantially accurate." App. at 44a. Nor did petitioner assert such a claim. The district court's finding was not that respondent inaccurately predicted the future, but that it violated the federal securities laws by materially misrepresenting the *current* financial condition of the company by improperly stating its loss reserves and net worth. As the court of appeals acknowledged, the understatement of loss reserves could have been detected from information available *at the time*. App. at 44a.

Instead, it concluded its analysis after holding clearly erroneous the district court's finding that respondent had *actual* knowledge of Elkhorn's insolvency at the time of the acquisition. App. at 31a.[7]

With respect to the Tillinghast reports, the Second Circuit agreed that "the district court's findings concerning the concealment of the . . . Reports [were] not clearly erroneous," and acknowledged that respondent had a duty to disclose the reports if they were material. App. at 33a. But the court of appeals determined that the Tillinghast reports—which demonstrated a $20 million understatement of Elkhorn's reserves in 1981—were not material. Although the court cited and quoted the objective materiality standard of *TSC Industries, Inc. v. Northway, Inc.*, 426 U.S. 438 (1976), it assessed the value of the omitted information to Delta's particular accounting and actuarial advisors, instead of examining its significance to a reasonable investor. App. at 34a-35a.

Thus, the court below effectively carved out an exception to the *TSC Industries* objective standard in cases where the investor has retained professional advisors. Further, the court of appeals held that the Tillinghast reports were not material because their disclosure "would not have changed events"

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7 The court of appeals also devoted an entire section of its opinion to an issue known in this case as "the account-date problem." It is unnecessary to dwell on that issue here because, as the court of appeals conceded, "the [district] court did not find a material misrepresentation or omission concerning the account date problem." App. at 38a. Thus, the court of appeals was pursuing a dead issue when it concluded, *in connection with the account date problem*, that under § 10(b), respondent did not act with scienter and that under § 12(2), respondent satisfied its burden of showing that in the exercise of reasonable care it could not have known that its statements were false.

The court of appeals did *not* address these legal issues with respect to Elkhorn's understatement of its loss reserve liability and corresponding overstatement of net worth, except for (a) acknowledging the critical fact that respondent could have detected Elkhorn's understatement of loss reserves from available information and (b) concluding (contrary to the trial court's finding) that respondent had no actual knowledge of insolvency at the time of sale.

(App. at 38a), contrary to this Court's holding that information need not be outcome-determinative to be material.

REASONS FOR GRANTING THE WRIT

This Court has periodically granted certiorari to decide important issues respecting the interpretation of the federal securities laws.[8] In this case, the Court is once again presented with the opportunity to resolve broad, recurring and particularly timely issues pertaining to the effective enforcement of the securities laws for the protection of investors and the public.

As the Court has emphasized, "[c]orporate financial statements are one of the primary sources of information available to guide the decisions of the investing public." *United States v. Arthur Young & Co.*, 465 U.S. 805, 810 (1984). And one of the most significant entries in the financial statements of banks, savings and loans, insurance companies and other financial institutions is their liability item for loss reserves—in the case of banks, losses on bad loans; and in the case of insurers, losses on insured events. If the reserves are not properly stated based on sound estimation techniques and the most accurate available historical and factual data, the financial statement will falsely portray the company's financial condition. As a result, investors relying on the

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8 *E.g.*, *Virginia Bankshares, Inc. v. Sandberg*, 111 S. Ct. 2749 (1991) (whether federal securities action may be based on statement of reasons and opinions); *Basic Inc. v. Levinson*, 485 U.S. 224 (1988) (application of § 10(b) to disclosure of corporate merger discussions); *Dirks v. SEC*, 463 U.S. 646 (1983) (whether a tippee who receives information from an insider has a duty to disclose); *Santa Fe Industries, Inc. v. Green*, 430 U.S. 462 (1977) (interpreting "manipulative or deceptive" requirement); *TSC Industries, Inc. v. Northway, Inc.*, 426 U.S. 438 (1976) (defining materiality standard); *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976) (whether scienter is required under § 10(b)); *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723 (1975) (whether a private § 10(b) action may be brought only by an actual purchaser or seller of a security); *Affiliated Ute Citizens of Utah v. United States*, 406 U.S. 128 (1972) (presumption of reliance when there is a material omission).

financial statement, as well as government regulators, may be deceived.

Indeed, understatements of reserves by financial institutions have given rise to many enforcement actions by the SEC and other government agencies in recent years, and the federal courts have entertained numerous actions by investors deceived by such misstatements. The Second Circuit's view—that an understated reserve is merely a wrong guess about future events and hence not subject to scrutiny under the securities laws—would blunt the effectiveness of those laws to protect the integrity of financial reporting by banks and insurers. And because accurate financial reporting underlies the integrity and stability of the financial institutions themselves, effective enforcement of the securities laws with respect to statements of reserve liabilities is essential not only for the protection of investors, but for the protection of the public and the economy as a whole.

I. THE SECOND CIRCUIT'S HOLDING THAT §§ 12(2) AND 10(B) DO NOT APPLY TO UNDERSTATEMENTS OF RESERVE LIABILITIES BECAUSE THEY ARE NECESSARILY BASED ON ESTIMATES—EVEN WHEN CURRENT INFORMATION DEMONSTRATING THE UNDERSTATEMENT IS AVAILABLE—CONFLICTS WITH DECISIONS OF THIS COURT AND OF OTHER CIRCUITS, AND WITH THE POLICIES UNDERLYING THE SECURITIES LAWS.

The Second Circuit's holding would severely limit the application of the federal securities laws to financial statements that do not fairly present the issuer's financial condition. What is more, the Second Circuit's holding conflicts with the decisions of this Court and of other circuits.

A. The Second Circuit's Holding Conflicts With Fundamental Principles Underpinning the Federal Securities Laws.

The " 'fundamental purpose' of the various Securities Acts, 'was to substitute a philosophy of full disclosure for the philosophy of *caveat emptor* and thus to achieve a high standard of business ethics in the securities industry.' " *Basic Inc. v. Levinson*, 485 U.S. 224, 234 (1988), *quoting SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 186 (1963). *Accord Affiliated Ute Citizens of Utah v. United States*, 406 U.S. 128, 151 (1972); *Santa Fe Industries, Inc. v. Green*, 430 U.S. 462, 477 (1977). Permitting a seller of stock to overstate the company's net worth by inaccurate estimation, when the information needed for an accurate disclosure is currently available, does not square with this policy of full disclosure.

Recognizing the fundamental importance of accurate financial statements to investors, the securities laws require publicly held corporations to file their statements with the Securities and Exchange Commission;[9] and to ensure their accuracy, SEC regulations require that such financial statements be audited to "determine[ ] whether [they] . . . have been prepared in accordance with generally accepted accounting principles." *United States v. Arthur Young & Co.*, 465 U.S. at 811.[10] Compliance with GAAP assures that "the financial statements, taken as a whole, fairly present the financial position . . . of the corporation . . . ." *Id.*

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9 *See* Securities Act of 1933, Schedule A (25)-(27), 15 U.S.C. § 77aa (filing of audited financial statement prior to registration of new stock issue); Securities Exchange Act of 1934, §§ 12(b)(1)(J)-(L), 15 U.S.C. §§ 78(b)(1)(J)-(L) (filing of audited financial statement prior to listing securities on an exchange); Securities Exchange Act of 1934, §§ 13(a)(2), 13(b), 15 U.S.C. §§ 78m(a)(2), 78m(b); 17 CFR §§ 249.310, 249.460 (filing of annual reports); Securities Exchange Act of 1934, § 14, 15 U.S.C. § 78n; Schedule 14A, Item 15, 17 CFR § 240.14a-101 (filing of audited financial statement in connection with proxy and information statements).

10 *See* Regulation S-X, 17 C.F.R. § 210 *et seq.*

If, as the Second Circuit held, loss reserve liabilities in financial statements need not be made as accurate as available information permits, then one of the most important liability items on corporate financial statements—reserves—will be exempt from the strictures of the federal securities laws. In principle, quantifying loss reserves is no different from calculating reserves for bad loans, reserves for bad debts, reserves for unsalable inventory, reserves for litigation liabilities, or reserves for the cost of environmental clean-up obligations.

As this Court has observed, "[f]inancial accounting . . . is hospitable to estimates . . . . Reasonable estimates may be useful, even essential, in giving shareholders and creditors an accurate picture of a firm's overall financial health . . . ." *Thor Power Tool Co. v. Commissioner of Internal Revenue*, 439 U.S. 522, 543 (1979). Because calculations of reserves for estimated losses and liabilities permeate financial reporting, the approach of the court below would effectively immunize almost *all* financial reporting from scrutiny under the federal securities laws.

The Securities and Exchange Commission has in recent years brought numerous securities fraud actions against financial institutions on the theory that the institution fraudulently misrepresented the adequacy of its loss reserve liabilities.[11] By the same token, the SEC and the Office of

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11 *See, e.g., SEC v. Wedgestone Financial*, No. 91-11849MA, Securities Exchange Accounting and Auditing Enforcement Release ("AAER") No. 318, [1987-91 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 73,787 (D. Mass. Sept. 24, 1991); *SEC v. Aulie*, No. 91-1663, AAER No. 305, [1987-91 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 73,774 (D.D.C. July 9, 1991); *SEC v. Parigian*, No. 90-11287-WD, AAER No. 257, [1987-91 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 73,726 (D. Mass. May 18, 1990); *SEC v. Financial Corp. of America*, No. 87-2578, AAER No. 153, [1987-91 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 73,622 (D.D.C. Sept. 21, 1987); *In re Texas Commerce Bancshares, Inc.*, Securities Exchange Act Release No. 24803, AAER No. 146, [1987-91 Transfer Binder] Fed Sec. L. Rep. (CCH) ¶ 73,615 (Aug. 17, 1987); *In re First Chicago Corp.*, Securities Exchange Act Release No. 34-24567, AAER No. 134, [1987-91 Trans-

Thrift Supervision are currently bringing actions and conducting investigations based on failures by savings and loan associations and others to report such liabilities accurately, as required by GAAP. These efforts would be nullified by the decision below that it is not a misrepresentation of financial condition to significantly understate reserve liabilities and thereby overstate net worth, even though the issuer could have provided an accurate financial statement based on available information.

At a time when many insurance companies and banking institutions are failing, the court of appeals' approach would weaken the integrity of published financial statements by loosening the standards of compliance with GAAP and the securities laws. Moreover, investors and government regulators relying on financial statements which—unknown to them—have serious understatements of reserve liabilities and corresponding overstatements of net worth, would have no remedy under the securities laws. The Second Circuit's decision thus raises issues of substantial importance to the enforcement of the nation's securities, banking and insurance laws and merits review by this Court.

B. The Second Circuit's Holding Conflicts With Decisions Of This Court And Of Other Circuits.

The court of appeals' ruling, that loss reserves in financial statements are necessarily the product of estimation or

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fer Binder] Fed. Sec. L. Rep. (CCH) ¶ 73,603 (June 10, 1987); *In re Continental Illinois Corp.*, Securities Exchange Act Release No. 24142, AAER No. 128, [1982-87 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 73,528 (Feb. 27, 1987); *SEC v. McMahen*, No. 85-2895, AAER No. 72, [1982-87 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 73,472 (D.D.C. Sept. 12, 1985); *SEC & OCC v. Fraser*, No. 84-2652, AAER No. 37, [1982-87 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 73,437 (D.D.C. Aug. 30, 1984); *In re Utica Bankshares Corp.*, Securities Exchange Act Release No. 20702, AAER No. 24, [1982-87 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 73,424 (Feb. 29, 1984); *SEC v. IntraWest Financial Corp.*, No. 84-0604, AAER No. 23, [1982-87 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 73,423 (D.D.C. Feb. 28, 1984).

"guesswork" and therefore cannot be the basis of claims under § 12(2) or § 10(b), is in conflict with this Court's recent decision in *Virginia Bankshares, Inc. v. Sandberg*, 111 S. Ct. 2749, 2757 (1991). *Virginia Bankshares* rejected outright the view that only misrepresentations of "hard" facts are actionable under the securities laws, and held that even misstatements of reasons, opinion or belief may constitute misrepresentations. Similarly, many courts of appeals have held, contrary to the reasoning of the court below, that projections are actionable under the federal securities laws if they do not have a sound factual or historical basis.[12]

If projections of the future can be scrutinized for securities violations, *a fortiori* the same is true for quantifications in financial statements of existing liabilities (including loss reserves). Falsely stated reserve liabilities, even when they involve estimation methods, are actionable when they lack a sound factual basis, and when more accurate information is available to the issuer. Other Circuits have squarely so held, in conflict with the Second Circuit's decision here. *Fine v. American Solar King Corp.*, 919 F.2d 290, 297-98 (5th Cir. 1990) (misrepresentation under federal securities laws to knowingly or recklessly represent that financial statements—which understated reserves for uncollectible accounts—complied with GAAP and fairly presented the financial position of the company), *cert. denied*, 112 S. Ct. 576 (1991); *Sirota v. Solitron Devices, Inc.*, 673 F.2d 566, 573-74 (2d Cir.) (understating reserves for excess and obsolete inventory actionable under § 10(b)), *cert. denied*, 459 U.S. 838 (1982);

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12 *In re Apple Computer Securities Litigation*, 886 F.2d 1109, 1113 (9th Cir. 1989), *cert. denied*, 110 S. Ct. 3229 (1990); *Acme Propane, Inc. v. Tenexco, Inc.*, 844 F.2d 1317, 1324-25 (7th Cir. 1988); *Isquith v. Middle South Utilities, Inc.*, 847 F.2d 186, 203-04 (5th Cir.), *cert. denied*, 488 U.S. 926 (1988); *Eisenberg v. Gagnon*, 766 F.2d 770, 776 (3d Cir.), *cert. denied*, 474 U.S. 946 (1985); *Cameron v. Outdoor Resorts of America, Inc.*, 608 F.2d 187, 194 (5th Cir. 1979), *modified on other grounds*, 611 F.2d 105 (5th Cir. 1980); *Marx v. Computer Sciences Corp.*, 507 F.2d 485, 490 (9th Cir. 1974); *G & M, Inc. v. Newbern*, 488 F.2d 742, 745-46 (9th Cir. 1973); *Johns Hopkins University v. Hutton*, 422 F.2d 1124, 1128-29 (4th Cir. 1970).

Blackie v. Barrack, 524 F.2d 891, 904 (9th Cir. 1975) (inflating a balance sheet by underreserving for uncollectible accounts receivable can be the basis of a § 10(b) class action), *cert. denied*, 429 U.S. 816 (1976); *In re Jiffy Lube Securities Litigation*, 772 F. Supp. 258, 262-63 (D. Md. 1991) (understating reserves for doubtful accounts and misrepresenting that financial statements complied with GAAP gives rise to claim under § 10(b)); *In re Meridian Securities Litigation*, 772 F. Supp. 223, 226-27 (E.D. Pa. 1991) (overstating net worth by understating loan loss reserves may give rise to claim under § 10(b)); *Urbach v. Sayles*, [1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 96,247, at 91,304-06 (D.N.J. 1991) (same); *In re Midlantic Corp. Shareholder Litigation*, 758 F. Supp. 226, 234-35 (D.N.J. 1990) (same); *First American Bank and Trust v. Frogel*, 726 F. Supp. 1292, 1297 (S.D. Fla. 1989) (same).

In light of the clear conflict of the decision below with the decisions of this Court and of other circuits, review by this Court is warranted.

C. The Second Circuit's Decision Raises Important Issues As To Whether A Seller's Liability Under §§ 12(2) and 10(b) Requires Actual Knowledge That Representations Concerning The Issuer's Reserves Are False.

In holding that respondent as a matter of law did not violate the securities laws, the court of appeals effectively carved out an exception to the settled law that a seller is liable under § 12(2) if it reasonably could have known that its statements were untrue, and is liable under § 10(b) if it made its misrepresentation recklessly.

Under § 12(2) of the Securities Act of 1933, a seller who makes a false statement is excused from liability only if it establishes that it "did not know, and *in the exercise of reasonable care could not have known*, of [the] untruth or omission." (Emphasis added.) Here, the Second Circuit acknowledged that respondent *could* have known that its bal-

ance sheet was false: in the words of the court of appeals, the understatement of loss reserves "*could have been* detected from information available as of that date." App. at 44a (emphasis added). That is all that the statute requires. Yet the court of appeals reversed, holding that the statement of a reserve liability not actually known to be false cannot be the basis of a claim. That interpretation of § 12(2), which conflicts with the plain language of the statute, warrants review by this Court.[13]

Similarly, the court of appeals' interpretation of § 10(b) was legally incorrect and contrary to the decisions of other circuits. This Court has left open the question of whether recklessness establishes scienter under § 10(b). *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 193 n.12 (1976). The great majority of the courts of appeals have concluded that it does. *E.g.*, *Van Dyke v. Coburn Enterprises, Inc.*, 873 F.2d 1094, 1100 (8th Cir. 1989); *Woods v. Barnett Bank*, 765 F.2d 1004, 1010 (11th Cir. 1985); *Dirks v. SEC*, 681 F.2d 824, 844-45 (D.C. Cir. 1982), *rev'd on other grounds*, 463 U.S. 646 (1983); *Sharp v. Coopers & Lybrand*, 649 F.2d 175, 193 (3d Cir. 1981), *cert. denied*, 455 U.S. 938 (1982); *Broad v. Rockwell Int'l Corp.*, 642 F.2d 929, 961 (5th Cir.), *cert. denied*, 454 U.S. 965 (1981); *Nelson v. Serwold*, 576 F.2d 1332, 1337 (9th Cir.), *cert. denied*, 439 U.S. 970 (1978); *Sundstrand Corp. v. Sun Chemical Corp.*, 553 F.2d 1033, 1044 (7th Cir.), *cert. denied*, 434 U.S. 875 (1977).

The Second Circuit stopped its analysis after finding (contrary to the district court) that respondent did not have actual

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13 Moreover, the court of appeals ignored findings by the district court supporting the conclusion that respondent knew or reasonably could have known of the overstatement of Elkhorn's net worth, including findings that respondent instructed Tillinghast not to complete its reports so as to avoid an accurate calculation of Elkhorn's required loss reserves, that respondent understood that the reports nevertheless demonstrated an understatement of loss reserves by more than $20 million, that no action was taken to remedy the loss reserve understatement demonstrated by the reports, and that the reports were concealed from respondent's own auditors. *See* Point III, *infra*, and Statement of the Case, *supra*.

knowledge of Elkhorn's insolvency. The court of appeals did not proceed to examine whether the evidence supported a finding of recklessness, nor did it remand for such a finding. Thus, the decision below squarely conflicts with the numerous decisions in other circuits holding that recklessness establishes scienter under § 10(b).

Because of the importance of the issue to the enforcement of §§ 12(2) and 10(b) and the conflict among the circuits, review by this Court is warranted.

II. THE SECOND CIRCUIT'S STANDARD OF MATERIALITY CONFLICTS WITH THE DECISIONS OF THIS COURT AND OF OTHER CIRCUITS.

The court of appeals held that respondent's concealment of reports by a professional actuary, which demonstrated the understatement of Elkhorn's loss reserves, did not violate the securities laws because the reports, in the court's view, were not material to Delta's decision to purchase the Elkhorn stock.[14] In so holding, the Second Circuit departed in two respects from the materiality standard established by this Court and other circuits.

First, the court of appeals carved out an exception to the well-established objective standard of materiality, and held that a subjective standard should apply when the investor retains professional advisors. Second, the court of appeals looked to whether the omitted information "would have changed events," instead of assessing whether the information would have been viewed by the reasonable investor as having significantly altered the total mix of information available.

In finding the Tillinghast reports immaterial as a matter of law, the court of appeals focused on the significance of the

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14 The existence and content of these actuarial reports was the only information the court of appeals found not to be material. The court of appeals did not dispute the district court's findings as to the materiality of respondent's misrepresentations respecting Elkhorn's gross understatement of loss reserves and consequent overstatement of net worth.

concealed reports to Delta's professional advisors, rather than to a reasonable investor:

> "We note that the application of [the materiality] standard in the instant matter concerns . . . the value of the omitted information to Peat Marwick and Conning, firms with actuarial expertise hired to make an independent inquiry with regard to the adequacy of those loss reserves."

App. at 34a-35a.

Indeed, there can be no doubt that the court applied a subjective materiality standard. The court categorically stated: "We do not address the materiality of documents such as the Tillinghast Reports in the context of . . . less sophisticated investors." App. at 35a n.4.

As this Court has repeatedly held, "[t]he question of materiality, it is universally agreed, is an objective one, involving the significance of an omitted or misrepresented fact to a reasonable investor." *TSC Industries, Inc. v. Northway, Inc.*, 426 U.S. 438, 445 (1976).[15] Thus, materiality does not depend on the sophistication of the particular investor, or on whether the investor has the benefit of sophisticated advisors. *Virginia Bankshares, Inc. v. Sandberg*, 111 S. Ct. at 2760-61 (materiality to be measured from standpoint of a reasonable investor, not that of a financial analyst); *Basic Inc. v. Levinson*, 485 U.S. at 240 n.18 ("We find no authority in the statute, the legislative history, or our prior decisions, for varying the standard of materiality depending on who brings the action . . ."); *TSC Industries, Inc. v. Northway, Inc.*, 426 U.S. at 449 (information is material under the federal securities laws if there is "a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available").

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15 *TSC Industries* arose under § 14(a) of the Securities Exchange Act of 1934. This Court adopted the *TSC Industries* standard of materiality for § 10(b) actions in *Basic Inc. v. Levinson*, 485 U.S. 224, 232 (1988).

Applying a subjective materiality standard when the investor has retained advisors would radically change the materiality analysis. One professional may or may not find another professional's opinion to be significant, while a reasonable investor would be very interested in assessing the opinions of both professionals, particularly if they are contradictory.[16] Thus, a subjective materiality standard would significantly impair the ability of investors to obtain redress under the securities law when they are prudent enough to retain professional advisors. In addition, a materiality standard that varies according to the specific expertise or viewpoint of particular advisors would be difficult for sellers to comply with and for courts to enforce. The standard of disclosure required of sellers of stock should not be lowered or raised depending on the particular interests of the investor's advisors. Review by this Court is required to insure that the courts enforce the securities laws against those who fail to disclose or misrepresent information that would be important to a reasonable investor, regardless of whether the investor has retained professional advisors.

The Second Circuit's materiality standard is legally deficient in yet another respect: the court of appeals reasoned that the concealed reports were not material because they "would not have changed events." App. at 38a. This Court's decisions establish that information need *not* be outcome determinative to be material. As the Court stressed in *TSC Industries*, materiality "does not require proof of a substantial likelihood that disclosure of the omitted fact would have caused the reasonable investor to change his vote"; it suffices that there is "a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available." *TSC Industries, Inc. v. Northway, Inc.*, 426 U.S. at 449; *Basic Inc. v. Levinson*, 485 U.S. at 231-32. A professional actuary's reports demonstrating that Elkhorn was insolvent 18 months before the

16 In this case, there was direct testimony that the Tillinghast actuarial reports would have been "of interest." App. 37a-38a.

purchase—in the context of a continually deteriorating financial condition during the interim—are plainly material under this standard.

Unlike the Second Circuit, other courts of appeals have followed this Court's mandate and held that information is material if it would have assumed actual significance in the investor's deliberations, irrespective of whether the undisclosed information would have changed the investment decision. *SEC v. MacDonald*, 699 F.2d 47, 49 (1st Cir. 1983); *SEC v. Blatt*, 583 F.2d 1325, 1331-32 & n.11 (5th Cir. 1978). Certiorari should be granted to resolve the conflict among the circuits and to correct the Second Circuit's deviation from the holdings of this Court.

III. THE SECOND CIRCUIT FAILED TO APPLY THE MANDATE OF FED. R. CIV. P. 52 THAT FINDINGS OF FACT NOT BE SET ASIDE UNLESS CLEARLY ERRONEOUS.

Certiorari should also be granted in the exercise of this Court's supervisory authority to correct an egregious arrogation of fact-finding power by the court of appeals. The Second Circuit violated Fed. R. Civ. P. 52(a)'s mandate that findings of the district court not be set aside unless "clearly erroneous."

The Court has "frequently . . . emphasized that '[w]here there are two permissible views of the evidence, the factfinder's choice between them cannot be clearly erroneous.' " *Amadeo v. Zant*, 486 U.S. 214, 226 (1988), *quoting Anderson v. Bessemer City*, 470 U.S. 564, 574 (1985). The court of appeals "oversteps the bounds of its duty under Rule 52(a) if it undertakes to duplicate the role of the lower court," and "[w]hen findings are based on determinations regarding the credibility of witnesses, Rule 52(a) demands even greater deference to the trial court's findings . . . ." *Anderson*, 470 U.S. at 573, 575.

The court below engaged in the very practices condemned in *Amadeo* and *Anderson* by drawing its *own* inferences from

the primary facts found by the district court. The following are among the district court's more significant factual findings—not one of which was disputed by the court of appeals: (a) Respondent understood that Elkhorn's loss reserve methodology was deficient (App. at 61a); (b) with knowledge of that deficiency, respondent retained an actuarial consultant but instructed the consultant not to calculate the required level of loss reserves (App. at 61a); (c) respondent understood that the actuarial reports demonstrated an understatement of loss reserves of more than $20 million as of the end of 1981, and it knew that Elkhorn's financial condition continued to deteriorate thereafter (App. at 62a, 63a); (d) respondent concealed the actuarial reports and the understatement of reserves from its *own* independent auditors (App. at 62a); (e) respondent failed to implement the recommendations of its actuarial consultant for properly calculating and correcting Elkhorn's loss reserves (App. at 62a); and (f) respondent intentionally concealed the actuarial reports from Delta and its consultants, and even denied that any such reports existed (App. at 63a-64a).

Based on these detailed findings, the district court specifically found that respondent knew that its representations concerning Elkhorn's loss reserve liability were materially false. App. at 65a. Plainly, this was a "permissible view[ ] of the evidence" under *Amadeo*. 486 U.S. at 226. The court of appeals "overstep[ped] the bounds of its duty under Rule 52(a)" by substituting its view of the evidence for that of the district court. *Anderson*, 470 U.S. at 573.

Further, as explained above, judgment in favor of Delta did not depend on the district court's finding that respondent had actual knowledge that its representations were false. A judgment for Delta could have been supported by lesser findings: under § 10(b), that respondent made its misrepresentations recklessly, and under § 12(2), that respondent reasonably could have known that its statements were untrue. The court of appeals arrogated to itself the role of a trial court when it held, as a matter of law, that no violation of §§ 10(b) or 12(2) had occurred, notwithstanding the ample

evidence outlined above showing that even if respondent did not know that its representations were false, it was at the very least reckless or negligent in not knowing. The court of appeals' decision is particularly egregious in light of its own recognition that respondent *could* have detected the understatement of the reserve liability with information available to it at the time. App. at 44a.

Further, the court of appeals cited no accounting standards, expert accounting testimony or other record evidence in concluding that respondent's gross understatement of loss reserves—which converted Elkhorn's insolvency into an apparent $18 million net worth—complied with GAAP and therefore with the securities laws. Rather, without disputing the district court's finding (App. at 60a) that Delta's expert witnesses were credible, the court of appeals adopted its *own* interpretation of what GAAP does and does not require, which conflicted with the relevant accounting standards and with the expert testimony accepted as credible by the trial court.[17]

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17 The Second Circuit concluded that the district court did not render a finding of fact on the issue of whether Elkhorn's balance sheet as represented complied with GAAP. App. at 49a. This conclusion was in error: the district court found that the balance sheet was not "complete and accurate in all material respects" and did not "present[ ] fairly the financial position of Elkhorn." App. at 67a. Accuracy, completeness, and fair presentation of financial position are the *sine qua non* of compliance with GAAP. *See United States v. Arthur Young & Co.*, 465 U.S. 805, 811-12 (1984), citing 1 AICPA Professional Standards (CCH) AU § 509 (1974); 1 AICPA Professional Standards (CCH), "Responsibilities and Functions of the Independent Auditor," AU § 110.01 (Nov. 1972); 1 AICPA Professional Standards (CCH), "The Meaning of 'Present Fairly in Conformity with Generally Accepted Accounting Principles' in the Independent Auditor's Report," AU § 411.04 (July 1975). Thus, the district court's finding that the balance sheet "did not 'present[ ] fairly the financial position of Elkhorn' " means that it ran afoul of GAAP.

Even assuming that the district court's findings were not clearly stated, the Second Circuit should not have made its own findings. "The District Court's lack of precision . . . is no excuse for the Court

The factual question of what GAAP requires is not properly decided in the first instance by a federal court of appeals; as recognized by this Court in *United States v. Arthur Young & Co.*, 465 U.S. 805, 811 n.7 (1984), the requirements of GAAP must be determined by the pronouncements of the accounting profession's governing bodies, such as the Financial Accounting Standards Board. No other circuit has presumed to set forth its own view of generally accepted accounting principles; to the contrary, other courts of appeals properly find generally accepted accounting principles solely from the accounting profession's pronouncements and the testimony of accounting experts. *E.g.*, *HCA Health Services of Midwest, Inc. v. Bowen*, 869 F.2d 1179, 1181 n.3 (9th Cir. 1989); *Spokane Valley General Hospital, Inc. v. United States*, 688 F.2d 771, 776 n.4 (Ct. Cl. 1982).

The court of appeals also violated Rule 52(a) when it set aside the district court's findings that the Tillinghast reports were material. Under *Amadeo*, 486 U.S. at 226, it was plainly a "permissible view[ ] of the evidence" for the district court to conclude that the Tillinghast reports would have been significant to Delta in making its investment decision, where they demonstrated that Elkhorn was insolvent only 18 months before Delta's purchase, and where Elkhorn's financial condition had deteriorated in the interim. Indeed, as the court of appeals acknowledged, there was *direct* testimony "that actuary reports showing a loss reserve deficiency of $20

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of Appeals to ignore the dictates of Rule 52(a) and engage in impermissible appellate fact finding." *Amadeo*, 486 U.S. at 228. Rather, the judgment for Delta should still have been affirmed because it is supported by the record. *Schweiker v. Hogan*, 457 U.S. 569, 585 & n.24 (1982) (a district court decision may be affirmed on any ground supported by the record). At most, the Court of Appeals should have remanded to the district court to supplement its findings of fact. *Icicle Seafoods, Inc. v. Worthington*, 475 U.S. 709, 714 (1986) ("If the Court of Appeals believed that the District Court had failed to make findings of fact essential to a proper resolution of the legal question, it should have remanded to the District Court to make those findings. . . . But it should not simply have made factual findings on its own.")

million would have been 'of interest.' " App. 37a-38a. The court of appeals engaged in impermissible appellate fact-finding when it nonetheless held that the reports were "stale" and therefore immaterial.

In short, the decision of the court below is antithetical to the principle of deference to the findings of the trier of fact embodied in Rule 52(a) and repeatedly emphasized by the decisions of this Court. This Court should grant review pursuant to its supervisory power over the federal judicial system to correct the Second Circuit's extreme departure from the accepted and usual course of appellate proceedings.

CONCLUSION

For the reasons stated above, this Court should grant certiorari in this case.

Dated: February 24, 1992

Respectfully submitted,

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APPENDIX

UNITED STATES COURT OF APPEALS

FOR THE SECOND CIRCUIT

No. 355—August Term, 1990

(Argued: December 6, 1990 Decided: October 1, 1991)

Docket No. 90-7528

DELTA HOLDINGS, INC.,

Plaintiff-Appellee,

—v.—

NATIONAL DISTILLERS AND CHEMICAL CORPORATION,

Defendant-Appellant.

Before:

KAUFMAN, NEWMAN and WINTER,

Circuit Judges.

Appeal from a judgment of the United States District Court for the Southern District of New York (John F. Keenan, *Judge*) awarding $24.3 million in damages, plus prejudgment interest, and ordering rescission of an acquisition of a reinsurer. Finding as a matter of law no omis-

sions or misrepresentations of material fact and no breach of warranty, we reverse.

JOSEPH P. DAILEY, New York, New York (Loren F. Selznick, James T. Southwick, Breed, Abbott & Morgan, New York, New York, of counsel), *for Defendant-Appellant.*

DAVID KLINGSBERG, New York, New York (Paul J. Curran, Alan F. Goott, Michael Braff, Joshua N. Lief, Kaye Scholer, Fierman, Hays & Handler, New York, New York, of counsel), *for Plaintiff-Appellee.*

WINTER, *Circuit Judge*:

This factually complex litigation arises out of a dispute over the disclosure of documents, representations, and warranties made by National Distillers and Chemical Corporation ("Distillers") in connection with the sale of its wholly-owned subsidiary, Elkhorn Re Insurance Company ("Elkhorn"), to Delta Holdings, Inc. ("Delta"). Following a bench trial before Judge Keenan, the district court held that Distillers violated federal securities law, committed common law fraud, and breached various express warranties. The district court awarded Delta $24.3 million in damages plus pre-judgment interest and ordered rescission of the entire transaction. We find as a matter of law that Distillers neither omitted to disclose material facts,

made material misrepresentations, nor breached its warranties. We therefore reverse.

BACKGROUND

Distillers, now named Quantum Chemical Corporation, is a diversified company primarily engaged in the business of producing chemicals and liquefied petroleum gases. Elkhorn was originally established for the purpose of acquiring and developing operating insurance or reinsurance subsidiaries to insure casualty and property risks of Distillers. Sometime thereafter, Elkhorn began to reinsure risks underwritten by other companies. The principal factual and legal issues on this appeal relate to contemporaneous (with the acquisition) determinations of the adequacy of financial reserves set aside by Elkhorn to cover future claims. An understanding of these issues requires a lengthy description of the evidence at trial, beginning with an overview of the methodologies of estimating loss reserves in the reinsurance industry.

1. *Loss Reserves and Reinsurance*

Risk-pooling is a form of diversification that reduces the dispersion or volatility of losses and is the essence of insurance. Reinsurance is the pooling among secondary insurers of portions of risks previously underwritten by primary insurers. In typical reinsurance transactions, primary insurers first underwrite risks in exchange for premiums from the insureds. To spread the underwritten risks further, primary insurers transfer or "cede" a portion of their risks to reinsurers, who accept the risks in exchange for premiums from the ceding companies. Reinsurers, in turn, may cede portions of their risks to sec-

ondary reinsurers or "followers" in what are commonly referred to as retroactive cessions.

Reinsurance contracts typically fall into two categories. A "treaty" is an agreement under which a reinsurer accepts a percentage participation in all risks of a certain type or class underwritten by the primary insurer (or another reinsurer) during a specified period of time. A "facultative contract" is an agreement under which a reinsurer assumes specific risks instead of an entire class of risks.

Reinsurers assume many types of risk by treaty or facultative contract. These include death (*e.g.*, life insurance), property loss (*e.g.*, fire insurance), and liability to third parties for personal injury or property damage (*e.g.*, professional malpractice insurance). The underwriting of third-party liability, known as "casualty risks," leads to complex problems of financing and accounting because assumption of third-party liability risks involves substantial delays or "tails" in the discovery and reporting of claims. These delays, as lengthy as fifteen or twenty years with some policies, such as medical malpractice insurance, inevitably create considerable uncertainty as to the calculation of future claims and of the reserves that must be set aside to pay those claims. Such calculations are at the heart of the present dispute.

In preparing periodic financial statements, a reinsurer must treat amounts of earned premiums as current income and amounts of future claims as offsets to current income. These loss reserves often represent the largest liability item on a reinsurer's balance sheet, and particularly the balance sheet of a casualty risk reinsurer. Loss reserves must be established for known claims ("case reserves") as well as for incurred-but-not-reported claims ("IBNR

reserves"). Case reserve estimates are less conjectural than IBNR reserves because case reserves are established immediately after a specific claim is reported. Case reserves are thus sums set aside to cover estimated losses based on reported claims. In contrast, IBNR reserves are sums set aside to cover losses for which claims have not been reported but must be estimated so the company can pay future claims. For that reason, reinsurers that underwrite casualty risks with long discovery or reporting delays often carry IBNR reserves that dwarf case reserves.

Under generally accepted accounting principles ("GAAP"), a reinsurer is obligated to make a reasonable estimate of IBNR liabilities. However, GAAP neither specifies a precise actuarial method nor requires that the reinsurer retain an independent actuary to prepare or review loss reserve estimates. Pertinent to the instant matter are three methods of estimating IBNR reserves: (1) the incurred loss development method; (2) the loss ratio method; and (3) the Bornhuetter-Ferguson method ("B-F Method"). Each of these methods is well known within the reinsurance industry.

The incurred loss development method projects future claims by using data from past claims experience. Judgment calls as to selection of pertinent data and its use are inherent in the incurred loss development method. The loss ratio method utilizes a flat percentage of loss for each dollar of premium. Under that method, the percentage may be applied to the reinsured risks as a whole or different percentages may be applied to particular categories of risk or treaties with other companies. The selection of the particular percentage(s) is also a judgment call(s) and based largely on the selector's view of future losses. Many of the judgment calls needed to implement the loss

development or loss ratio methods rely upon historical data as to loss reporting patterns.

The B-F Method is a hybrid of the incurred loss and loss ratio methods. It divides expected underwriting losses for each year into two categories—expected unreported claims and expected losses based on reported claims. As an account year matures, estimates of unreported claims are replaced by reported claims, thereby improving the accuracy of the ultimate estimate. To apply the B-F Method, therefore, a reinsurer must consider two parameters—first, the initial expected loss ratio and, second, the expected reporting pattern for a particular account year. The initial-expected loss ratio is selected on the basis of a variety of factors such as the general performance of the industry, the reinsurer's own historical loss ratio, the break-even loss ratio, and a comparison of expected reported losses with actual reported losses in previous years. However, because the initial-expected loss ratio is used only to the extent that claims are unreported, the ratio's importance for a particular account diminishes over time. In recent account years, the initial-expected loss ratio represents the lion's share of the final liability estimate, whereas in older account years, the ratio has a diminished effect on the final estimate because increasingly larger portions of the losses incurred during those years resulted from claims that have already been reported.

The second parameter in B-F analysis is the percentage of total losses, past and future, reported to date. This percentage is estimated on the basis of historical reporting patterns—*i.e.*, the same reporting patterns that can be used to make direct extrapolations under the incurred loss development method. Reliable historical data on loss reporting patterns is thus even more essential to use of the

B-F method than it is to use of the loss development and loss ratio methods.

Among the methods of presenting historical loss reporting patterns are formatted data sheets known as "loss development triangles." Such triangles consist of a left-hand column of account dates (*i.e.*, years in which policies covered by the reinsurance treaty were underwritten); a column to the immediate right stating claims reported during the first year; and additional columns to the right stating cumulative reported claims several years into the "aging" of a particular account. So arranged, the data resemble a triangle because cumulative claims figures are available for several years with respect to the oldest accounts but for one less year with respect to accounts beginning in the succeeding year, and so on. A hypothetical loss development triangle (000's omitted), prepared in 1986 and reflecting data through December 31, 1985, might appear as follows:

Fig. 1

Account Year	*1*	*2*	*3*	*4*	*5*
1981	7000	7700	9400	9600	9700
1982	5000	6400	7100	7700	
1983	7200	8100	8900		
1984	8100	9800			
1985	7900				

Loss development triangles simplify the task of identifying patterns in claim reporting by clarifying numerical trends. For example, in the hypothetical one can divide cumulative total reported claims in one year of an account into cumulative total claims reported by the next year to obtain loss development ratios. Based on the hypothetical triangles, such ratios would appear as follows:

Fig. 2

	1	*2*	*3*	*4*
Account Year	*2*	*3*	*4*	*5*
1981	1.100	1.221	1.021	1.010
1982	1.280	1.109	1.085	
1983	1.125	1.099		
1984	1.210			
1985				

Averaged ratios serve as a means of predicting future losses.

Similarly, given reported losses in Fig. 1 during the first year of 1981 accounts of $7 million and reported losses at the end of five years of $9.7 million, one might conclude, applying the incurred loss development method, that for every $7 million in first-year reported losses, $2.7 million should be set aside as IBNR reserves to cover losses anticipated during the subsequent four years. Or, for purposes of the B-F Method, one might estimate from Figs. 1 and 2 that a particular percentage of total losses will be incurred within a given number of years. All of the calculations described along with others may also be used to arrive at the percentage(s) to be used under the loss ratio method.

Judgments must inevitably be made in the use of these calculations. For example, if loss development ratios regularly rise from one year to the next, an average of those ratios would probably understate future losses. Selection of a development factor based on the latest ratio and the rate of annual increase rather than the average would seem more reliable.

It must be emphasized that no actuarial method is so accurate that it eliminates conjecture in the calculation of IBNR liabilities. Even case reserve decisions involving reported claims entail uncertainty as to the amount of final loss. IBNR reserves, however, are far more conjectural because they must be calculated without knowing even the number of claims. Overly conservative loss estimates are no answer. Overestimated reserves are harmful because reinsurance premiums are competitive and a competitive return on investment is necessary to attract investors. Methods that cause substantial excess reserves to be set aside may cause losses to a reinsurer for lack of underwriting or investment.

Finally, in the reinsurance industry history may be an imperfect guide to the future, particularly with regard to casualty risks. The incidence of claims may change, the costs of defense may increase, and inflation may lead to unexpectedly high losses per claim. Even the conservative B-F Method relies on assumptions as to future events and conditions, that, if wrong, will lead to substantial errors in the final estimate.

Consequently, regardless of the actuarial method used, the preparation of, and reliance upon a net worth calculation in a balance sheet for a casualty risk reinsurer is based in large part upon informed guesswork. One cannot, therefore, expect equivalent certainty in a balance sheet's statement of loss reserves and its statement of more determinable items, such as outstanding principal and interest on debt instruments. It is for that reason that GAAP neither specifies a precise method of estimating loss reserves nor even requires that an actuary prepare or review loss reserve estimates. Although this opinion entails extensive discussion of loss development triangles,

GAAP does not require that they be used in determining appropriate loss reserves.

This extended discussion of loss reserves and the reinsurance industry is in part only a prelude to an explanation of a final detail regarding loss development triangles central to the instant dispute. Because such triangles are designed to assist in estimating the amount of unreported claims as of specific dates, the triangles must accurately incorporate the lag in the reporting of claims to reinsurers if unreported claims are to be estimated reliably. Underwriting claims should thus be tallied in the year in which the reinsurer actually learns of the claims.

To illustrate, if, by some chance, claims amounts in Fig. 1 were based on the date of the report of claims to ceding companies or brokers—*e.g.*, some claims reported to the reinsurer in 1982 would be listed under 1981, when the ceding company or broker learned of them, and so on through each year—the numbers listed in Fig. 1 might appear as follows:

Fig. 3

Account Year	*1*	*2*	*3*	*4*	*5*
1981	7300	8700	9500	9675	9700
1982	5800	6800	7500	7700	
1983	7800	8500	8900		
1984	9100	9800			
1985	7900				

Fig. 2, involving loss development ratios based on Fig. 1, would then appear as follows:

Fig. 4

	1	*2*	*3*	*4*
Account Year	*2*	*3*	*4*	*5*
1981	1.192	1.092	1.018	1.003
1982	1.172	1.103	1.027	
1983	1.090	1.047		
1984	1.077			
1985				

It is readily apparent from a comparison of Figs. 1 and 2 with Figs. 3 and 4 that use of the date on which a claim is reported to a ceding company or broker rather than the date on which it is reported to the reinsurer will understate the historic lag in reporting to the reinsurer and will, if not compensated for, cause an underestimation of future unreported claims.

A final word is necessary on the detection of the use in loss development triangles of dates of claims reports to ceding companies or brokers instead of dates of reports to reinsurers. An actuary using Fig. 3 on the assumption that the cumulative losses listed for each account year were based on dates of reports to reinsurers would be unable to detect an error in that assumption simply by analyzing Fig. 3. However, if a new triangle including data for 1986 were constructed, the error would become apparent. Most of the loss amounts for the latest year in Fig. 3 would be increased as some of the claims reported to the reinsurer in 1986 would be allocated to 1985, the year in which those claims were reported to the ceding company or broker. (This assumes that the date of report to the reinsurer is never more than a calendar year later than the date of the report to the ceding company or broker.) The new triangle might appear thusly:

Fig. 5

Account Year	*1*	*2*	*3*	*4*	*5*	*6*
1981	7300	8700	9500	9675	*9715*	9720
1982	5800	6800	7500	*7825*	7950	
1983	7800	8500	*9100*	9200		
1984	9100	*10150*	10400			
1985	*9000*	10000				
1986	8100					

Because conventional loss development triangles use final year-end (or other completed time periods) reported-claims figures, the difference between the emphasized numbers in Fig. 5 and the corresponding figures in Fig. 3 would alert an actuary to a problem. Finally, we note that while the only numbers changing in Figs. 3 and 5 might be for claims reported in the year 1985—note that this is not the date 1985 in the left-hand column, which reflects the date of the beginning of an account, but rather the aging year at the top that is 1985 for the particular account—the skewed historic lag period would be built in for all prior years. For example, if yet a new triangle were constructed with 1987 figures and the parenthesized assumption held true, the numbers that are emphasized in Fig. 5 would be stable, but the numbers in the succeeding year would now change. Nevertheless, the figures for each account year would contain losses that had been reported in a later year.

2. *Elkhorn's Reinsurance Activities*

In 1972, when Elkhorn, which was licensed in Kentucky and New York, began to broaden its business by reinsuring third-party risks, Robert Norton became its president. Norton joined Distillers as an accountant in

1946. He became an executive in 1949 and a corporate officer in 1963. Norton had no actuarial training or managerial experience in the reinsurance industry.

Elkhorn's third-party underwriting continued to expand until, by 1983, outside business represented the largest portion of Elkhorn's activities. A substantial portion of Elkhorn's outside or "assumed" business consisted of reinsuring casualty and ocean marine risks with long delays or "tails" in the reporting of losses. As a result, assessments of Elkhorn's net worth substantially depended upon projections of future claims liability. To calculate IBNR reserves, Elkhorn used the loss ratio method. It recorded sixty-five percent of earned premiums as IBNR reserves unless a ceding company recommended another IBNR reserve level with regard to a particular treaty, in which event Elkhorn followed the ceding company's recommendation. The loss ratio method—specifically, the sixty-five percent formula with a later modification by which incurred losses were retained in loss reserves—remained Elkhorn's method for determining IBNR reserves until its acquisition by Delta.

As early as 1981, however, Norton and other Elkhorn executives became concerned over the accuracy of their loss reserve estimates. In October 1981, Norton asked an outside actuarial firm, Tillinghast, Nelson & Warren ("Tillinghast"), to study Elkhorn's loss reserves and to recommend a more sophisticated actuarial method. As part of Tillinghast's written project outline, Greg Leonard, a Tillinghast actuary, proposed that Tillinghast recommend an actuarial method and calculate an appropriate level of loss reserves. After reviewing Leonard's proposal, Norton and Ramsey Joslin, Elkhorn's chief financial officer, instructed Leonard to proceed with the study

and recommendation but not to calculate a suggested level of loss reserves.

In February 1982, Tillinghast completed its study and delivered three bound sets of a two-volume report ("February Report") to Norton. Norton gave one copy of the Report to Elkhorn's controller, James McGurty. Norton testified that he gave another copy to the company's chief underwriter, Terry Brewer, but at trial Brewer could not recall whether he actually received a copy. Norton kept the third set for his own use, placing it in the credenza in his office. McGurty kept the Report in his files.

The February Report did not explicitly state that Elkhorn's loss reserves were deficient. However, its discussion and exploration of methodologies did suggest problems with Elkhorn's IBNR reserve estimates. Addressing the merits of various actuarial methodologies, the February Report: (i) observed that the incurred loss development method "can lead to erratic and unreliable projections" because "a small swing in early reporting results in a very large swing in ultimate projections"; (ii) cautioned that the loss ratio method, with which Elkhorn was calculating its loss reserves, "has the advantage of stability, but . . . ignores actual results as they emerge"; and (iii) recommended that in the future Elkhorn determine its IBNR reserves by the B-F Method, which it described in detail.

Among various appendices to the report were detailed worksheets from which Elkhorn's IBNR reserves could be calculated according to the B-F Method. These calculations were not completed. The worksheets were based on loss development triangles prepared manually from Elkhorn's accounting records by Tillinghast. There was

evidence at trial that, if the calculations had been completed, they would have disclosed an IBNR loss reserve deficiency of approximately $10 million. The February Report also noted that, when data based on treaty categories became available through computerized bookkeeping, a refined B-F analysis based on such data would be even more informative than the use of the worksheets in the appendices. As an interim measure, while Elkhorn would be computerizing its bookkeeping, Tillinghast recommended increasing Elkhorn's assumed loss ratio from sixty-five percent to roughly eighty percent.[1]

Norton testified that he never completed the calculations demonstrating a $10 million deficiency in IBNR reserves because that calculation would have become obsolete as soon as treaty-category data became available upon Elkhorn's planned conversion to computerized bookkeeping. However, based on McGurty's testimony that Norton had stated that the February Report estimated a $10 million deficiency, the district court disbelieved Norton's denial of such a calculation, a finding that is not clearly erroneous.

Norton requested that Tillinghast prepare another report on three cancelled reinsurance treaties (collectively, the "Barrett Treaties") that had not been included in the February Report. In April 1982, Tillinghast delivered this second report ("April Report"), which, unlike the earlier one, included all requisite calculations and explicitly

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1 Squabbling over the proper characterization of the February Report has marked this litigation. The Report's text discusses nothing but methodology. The appended worksheets, however, which indicate how to test Elkhorn's loss reserves under the B-F Method, would justify the district court's characterization of the Report as "more than a methodology study." We will not enter this unproductive squabble but let the contents of the Report, as described in the opinion, speak for themselves.

stated that Elkhorn faced IBNR losses on the Barrett treaties of approximately $13.2 million. Elkhorn at that time was carrying on its books IBNR reserves of only $2.3 million for these treaties. The total deficiency in IBNR reserves estimated by completing the worksheets appended to the February Report and by the April Report was thus about $20 million. After consulting with Brewer about the deficiency revealed by the April Report, Norton purchased a $10 million loss transfer policy from the Continental Insurance Company (the "Continental Agreement") to cover the Barrett Treaties in exchange for a $5 million premium.

The seeds from which the present dispute germinated were planted in late 1982 when the computerization of Elkhorn's bookkeeping was completed. This computerization was based on software called STREAM which Elkhorn purchased from another reinsurer. (The computer was in Kentucky and used for Distillers' other businesses, Elkhorn being too small to have its own system). STREAM allowed treaty-category analysis as recommended by the February Report, and Norton generated treaty-category data from STREAM to construct loss development triangles as of December 31, 1982. Using these triangles, Norton estimated a deficiency far below $10 million. Although there is no evidence or district court finding that Norton realized it at the time, the triangles were, as he testified at trial, "all wrong."

The problem with Norton's triangles lay in STREAM. Whatever merits STREAM might have had as a system for maintaining and retrieving records or for analyzing data for other purposes, it had a serious deficiency so far as the construction of loss development triangles was concerned. Dates of the reports of claims to Elkhorn were in a STREAM file but were not separately retrievable. Dates

of reports of claims to ceding companies or brokers were separately retrievable as report dates. The only report date retrievable by STREAM was thus not the date of a report of a claim to Elkhorn, "book date," but rather the date of a report of a claim to the ceding companies or brokers, in the lexicon of this litigation, "account date." STREAM data thus produced triangles like Fig. 3, *supra*, instead of like Fig. 1.

John Cascio, Elkhorn's assistant controller, understood that STREAM reported claims reports as of account dates but did not discuss this issue with Norton. Cascio had no knowledge of the effect such data had on loss development triangles. For Norton's part, he may have known (Norton denied knowing, Cascio "assumed" Norton knew) that account-date data was being used but, if he did, there is no evidence that he knew that it would impair the predictive value of the triangles.

3. *Delta's Acquisition of Elkhorn*

At the time of Delta's acquisition of Elkhorn, the reinsurance industry had been suffering a protracted slump attributable to excess underwriting capacity and widespread inflation. Many reinsurance companies, especially followers unable to dictate terms and premiums, were battered by stiff price competition and underwriting losses. Elkhorn was no exception. From 1979 to 1982, the company suffered a series of underwriting losses, posting modest overall profits only because investment income exceeded those losses. Consequently, by 1980, Norton and other senior executives at Distillers began to believe that Elkhorn's business was, as the district court put it, "going sour."

In April 1983, Distillers discontinued all new third-party underwriting and began to explore ways of liquidating or selling its reinsurance business. Early that month, Norton contacted Arthur Deters of American Risk Management, Inc. ("ARM"), the entity then responsible for Delta's day-to-day management and later responsible for managing Delta's operating subsidiaries. At a meeting with Deters on April 6, 1983, Norton and Joslin disclosed Distillers' decision to discontinue Elkhorn's third-party underwriting and asked if ARM could assist Elkhorn in one of three ways—(1) managing an orderly wind-down (or "run off") of Elkhorn's reinsurance treaties, (2) making private and discreet inquiries about possible buyers for Elkhorn, or (3) proposing to Delta that it purchase Elkhorn's third-party reinsurance business.

ARM chose to pursue the third option, and in early May representatives of ARM and Distillers met in New York where they agreed to explore the possibility of selling Elkhorn to Delta for the book value price of $18 million. In June, senior underwriters from ARM, Lawrence Bell and Bryan Murphy, and an actuary from Peat Marwick, Alan Kaufman, visited Elkhorn's offices on Delta's behalf, interviewed the Elkhorn staff and reviewed various underwriting records. They were told about Elkhorn's problems with the Barrett Treaties and about the $10 million Continental Agreement. Norton showed his December 31, 1982 loss development triangles, based on STREAM data, to Kaufman and indicated that Tillinghast had educated him as to the B-F Method. Norton did not reveal the existence of either Tillinghast Report but rather stated that he had learned the B-F Method without having to pay for a study.

Bell reported to Delta that Elkhorn was rather disorganized, that errors were found in computerized

data regarding two randomly selected treaties, and that "a thorough audit . . . on all major accounts" was necessary. His report concluded with the statement that "a thorough IBNR review must be made." Kaufman reported to ARM that he disagreed with the methodology by which Elkhorn was estimating loss reserves and concluded that, on a brief review of methodology and subject to several "unknowns," those reserves were deficient by some $5 million.

After further meetings, on July 19 Distillers and Delta reached an agreement in principle to sell the capital stock of Elkhorn for the book value price of $18 million. At the time, the book value shown on Elkhorn's June 30, 1983 balance sheet was $26,472,000—a figure that included both Elkhorn's third-party reinsurance business, which Delta wished to buy, and its captive business, which Distillers intended to retain. Consequently, the parties agreed that Distillers would prepare a June 30 balance sheet segregating third-party and captive business specifically for the merger. These terms and conditions were incorporated in a letter of intent dated July 25, 1983.

For Delta, the two most important aspects of Elkhorn's financial health were the value of its bond portfolio and the adequacy of its loss reserves. Kaufman testified that, like most companies of comparable size, Elkhorn did not have an actuary. John Ryan, an ARM executive who represented that firm in the Elkhorn acquisition, testified that he also knew that Elkhorn lacked actuarial expertise.

As a result, Delta's acquisition was conditioned on receiving an opinion from an outside actuarial firm, Conning & Co. ("Conning"), as to the adequacy of Elkhorn's loss reserves, and an opinion from an outside accounting firm, Peat Marwick, Mitchell & Co. ("Peat Marwick"), as

to the accuracy of Elkhorn's June 30, 1983 balance sheet, including of course Peat Marwick's view of the adequacy of loss reserves. Delta offered to allow Distillers to name an actuary to participate in the loss reserves examination, but Distillers stated that it was satisfied with Conning.

The Stock Purchase Agreement contained numerous protective warranties by Distillers, discussed in greater detail *infra*. In Section 4 of the Agreement, Distillers agreed to give Delta's actuarial and auditing representatives "reasonable access" to its books and records. In Section 5(f), Distillers warranted the completeness of its books and records, the fact that they had been maintained in accord with accepted insurance practices, and their accurate reflection of Elkhorn's financial status. In Section 5(g), Distillers warranted that the June 30, 1983 balance sheet was maintained in accord with GAAP and fairly presented Elkhorn's financial position. Elkhorn further guaranteed in Section 8(g) that all tax liabilities had been provided for and guaranteed that the market value of its bond portfolio would be no more than $1,635,000 below its book value as of August 31, 1983. Finally, in Section 12 it was also agreed that, within roughly two weeks after the acquisition, Delta would prepare a balance sheet for September 30, 1983, and Distillers would reimburse Delta for any difference between the net worth as shown on that balance sheet and $18 million. Any dispute over the balance sheet was subject to a binding decision by Peat Marwick.

Delta's representatives thereafter examined Elkhorn's books and records and Norton explained the business and actuarial practices of his company to Delta's representatives. In an August meeting with Ryan of ARM, Robert Brian, the actuary heading up Conning's study, and Gary Ransom, also of Conning, Norton explained that Elkhorn

had been calculating its loss reserves either by applying the flat sixty-five percent loss ratio or by following the recommendation of a ceding company. In that conversation, he mentioned that he had tested Elkhorn's loss reserves by applying the B-F Method which, he said, he had learned from Tillinghast. According to Ryan, Norton said he obtained this instruction without having to pay for it and never mentioned the existence of either Tillinghast Report, although he was asked whether Elkhorn had had actuarial studies done. It is agreed that, at no time prior to the acquisition, were the Tillinghast Reports physically given to representatives of Delta.

On August 26, 1983, Conning delivered a written report to ARM concluding that Elkhorn had a loss reserve surplus of approximately $7.5 million as of December 31, 1982. Shortly thereafter, Conning revised its estimate and opined that Elkhorn's reserve surplus was about $1.6 million, adding the caveat that actual losses "may vary significantly from our estimates since underlying data is quite variable and difficult to project." Conning appears to have been using loss development triangles based on STREAM, and thus on account-date data.

During the same period in which Conning was preparing its assessment of Elkhorn's loss reserves, Peat Marwick's auditors spent some 327 hours examining Elkhorn's books and records. In the course of this effort, loss development triangles based on claims up to June 30, 1983 were developed from STREAM data. In mid-September, Amy Factor, a Peat Marwick actuary, noticed that some amounts of reported claims on the December 31, 1982 loss development triangles differed from the amounts of reported claims for the same time periods on the June 30, 1983 triangles, differences similar to the changes illustrated in Figs. 3 and 5, *supra*. Of course,

the very fact of changes in amounts of reported claims for closed time periods revealed a problem, as described *supra* in connection with Figs. 3 and 5.

When Factor asked Norton why loss amounts for closed time periods were changing, he had no answer but referred her to other Elkhorn personnel. They in turn explained to Factor that the changes occurred because STREAM retrieved account rather than book dates for reported claims data. Factor informed either Kaufman or David Wasserman, another Peat Marwick actuary, of her discovery. At their instructions, she attempted to contact Conning but apparently never got through. Kaufman testified that he left a message at Conning for Brian detailing the facts concerning STREAM's use of account rather than book dates. Brian denied ever learning of this fact before Delta's acquisition of Elkhorn. Kaufman also testified that he informed Ryan of ARM about the Elkhorn triangles being based on account-date data. Ryan denied ever learning of this problem before the acquisition of Elkhorn.

In the glow of hindsight, the parties agree that calculating loss development triangles based on account-date data will, if not compensated for, result in a serious understatement of IBNR reserves. One of Distillers' own experts testified that proper corrections for the account-date distortion caused by Elkhorn's computer program might have revealed a loss reserve deficiency of as much as $108 million as of the date that Elkhorn's books represented a net worth of $18 million. The account-date distortion was, therefore, indisputably significant.

However, no substantial corrective action was taken as a result of Factor's discovery. Other than increasing loss reserves for the year 1982, Peat Marwick took no steps in

response to the problem. (Brian of Conning and Ryan of ARM denied ever learning of it.) The failure of Conning to revise its prior reported opinion or to react to his phone message appears not to have troubled Kaufman. Kaufman did not perceive, or take steps to learn of, the peril in relying upon account-date data. There is no evidence of any effort to determine how the account-date data might be compensated for. No inquiry appears to have been made at the time of the possibility of altering STREAM to use book-date data. Moreover, STREAM output was based on raw data in Elkhorn's files and manual retrieval of book dates was obviously possible, as Tillinghast had done before Elkhorn computerized its bookkeeping in late 1982. However, Kaufman never sought, or even inquired about, manual assembly of book-date data. As noted above, had that data been obtained and incorporated into the loss development triangles, Elkhorn's insolvency would have been revealed.[2] Nor, apparently, was consideration given to delaying the acquisition until book-date data was acquired.

One reason for the casual reaction to Factor's discovery appears to have been Kaufman's belief that the account-date problem affected only the loss amounts for the year 1982. He thus compensated for a possible underestimation of loss reserves only for that year. According to Kaufman's testimony, he and Wasserman conferred and "agreed that the loss ratios looked reasonable except for 1982 and the 1982 loss ratio out of the data did not look

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2 This statement must be qualified by the observation that a conclusion of insolvency would have been premised upon the loss development triangles being an accurate predictor of the future. Had the actual claims experience in the future been substantially more favorable than that predicted by the triangles, insolvency might not have resulted. With hindsight, however, we can say that properly prepared triangles would have led to an accurate prediction.

reasonable and we had adjusted it so we thought we had a reasonable conclusion." (This testimony speaks volumes about the degree of guesswork that goes into estimates of loss reserves). Of course, the account-date problem affected every year, as the discussion in connection with Figs. 3-5 explains. Although the issue does not affect our ruling, it is possible that Factor's discovery may have been based on numbers changing only in the year 1982. (The illustrations in her testimony concerned that year.) Kaufman may thus have assumed that claims reports for only that year were affected, missing the facts that account dates were built into prior years and reporting lags were thus understated throughout.

Kaufman testified that his belief that the account-date problem was limited to 1982 was based upon Factor or Wasserman having been so informed by Norton. This hearsay testimony—seemingly at odds with an auditor's responsibilities to carry out an independent investigation—was objected to and properly admitted solely to explain Kaufman's actions and not for its truth. Factor did not substantiate Kaufman's story and testified that Norton indicated that he did not understand the problem and referred her to Elkhorn personnel who accurately informed her as to what data was being used. Wasserman did not testify. (A memorandum by Factor states that Wasserman believed that use of account dates was "not a problem" and could be compensated for.) There is thus no competent evidence, nor did the district court find, that Norton or anyone else at Elkhorn misrepresented the nature or implications of the account-date data from STREAM on which the loss development triangles were based.

Thereafter, Peat Marwick certified Elkhorn's loss reserves. It concluded that Conning's estimates were

somewhat optimistic and that Elkhorn would face an IBNR loss reserve shortfall of $3.5 million. In addition, Peat Marwick decided to adjust Elkhorn's bookkeeping on the Continental Agreement, thereby adding another $5 million deficiency to the $3.5 million IBNR deficiency. Based on these estimates, Peat Marwick advised ARM that it could not certify Elkhorn as fully reserved unless future liabilities were discounted to reflect the earning potential of Elkhorn's invested assets, a less conservative approach that, although arguably permissible under GAAP, had not been used by Elkhorn in the past. Only after Delta had agreed to discount future liabilities on the June 30, 1983 segregated balance sheet did Peat Marwick certify Elkhorn's reserves adding an explicit caveat that "[i]nsurers who establish claim reserves by applying selected loss ratios to earned premium (such as Elkhorn) often understate IBNR due to management's optimism in making loss ratio selections."

On September 30, 1983, Delta's acquisition of Elkhorn closed in Hamilton, Bermuda. Norton remained as president of the renamed entity, Delta Re; McGurty remained as controller. During the post-acquisition period, Peat Marwick reviewed the September 30 balance sheet pursuant to Section 12 of the Stock Purchase Agreement. Peat Marwick concluded that the balance sheet was in accord with GAAP and stated that it was unaware of any appropriate modifications. Delta therefore did not request reimbursement on the ground that Elkhorn's net worth was less than $18 million on that date.

Although the inadequacy of account-date data was recognized by Delta and a project was undertaken to convert Delta Re's computerized bookkeeping to use of book dates, there was little urgency about the matter, and Delta Re continued to rely upon account-date data until the

latter part of 1984, as Delta's own computers were gradually put into use. In fact, there is little evidence of any interest on the part of Delta's top management in the account-date problem until May 1984, when it was explored by Delta's advisory committee prior to a board of directors meeting. Even at this point, however, no one at Delta seems to have appreciated the full significance of the continued use of account-date data. In this period of time, Brian of Conning made further estimates of loss reserves based on loss development triangles containing STREAM data. Just as Kaufman thought that only the year 1982 was affected in Factor's triangles, Brian took corrective measures on his 1984 triangles only for the year 1983.

Meanwhile, Delta Re's fortunes declined further, as did those of the reinsurance industry generally, as a result of underestimated loss reserves. In July 1984, special examiners from the Kentucky Insurance Department began an investigation into Delta Re's financial condition, eventually concluding that the company's loss reserves had been deficient by some $38 million at the end of 1982. During the course of that investigation, state examiners told Norton that they planned to ask Tillinghast to perform a more detailed loss reserve analysis. Norton made no mention to anyone at Delta Re that Tillinghast had done work for Elkhorn in 1982.

On September 14, 1984, Norton resigned. John Ryan succeeded Norton as president, and, two months later, found the February Report in the credenza behind Norton's former desk. In early January 1985, Delta Re discovered the April Report elsewhere in Elkhorn's records.

On May 29, 1985, the State of Kentucky seized Delta Re's assets and commenced liquidation proceedings.

According to state examiners, the company had been insolvent since the end of 1982. By the time that the company was seized, Delta had contributed some $6.3 million to its acquisition above and beyond the $18 million purchase price paid to Distillers.

4. *The Proceedings in the District Court*

On May 3, 1985, Delta commenced the instant litigation. The complaint alleged breach of various warranties contained in Sections 5 and 12 of the Stock Purchase Agreement ("SPA") (Count I); common law fraud and deceit (Count II); violations of Section 12(2) of the Securities Act, 15 U.S.C. § 77*l* (Count III); violations of Section 10(b) of the Securities Exchange Act, 15 U.S.C. § 78j, and Rule 10b-5 promulgated thereunder, 17 C.F.R. § 240.10b-5 (Count IV); a pattern of racketeering under the Racketeer Influenced and Corrupt Organizations Act ("RICO"), in violation of 18 U.S.C. § 1962(c) (Count V); violations of the New York General Business Law (Count VI); and negligent misrepresentation (Count VII).

On April 8, 1988, the district court granted summary judgment in favor of Distillers on Delta's claim for breach of Section 12 of the SPA. Observing that Section 12's net worth guarantee, see Note 4 *infra*, was accompanied by a host of procedures and remedies, including "final and conclusive and binding" arbitration before Peat Marwick. Judge Keenan held that Section 12 created no independent cause of action for breach of warranty beyond the procedures enumerated in the provision itself. The district court also granted summary judgment in Distillers' favor on Delta's racketeering claim, concluding that the misrepresentations, if any, were made in connection with a single acquisition and were insufficient to constitute the requisite pattern of "racketeering" acts under RICO.

The district court denied Distillers' motion for summary judgment on Delta's remaining claims, explaining that "[a]lthough Delta Holdings [through its agents, Peat Marwick and Conning] knew that Elkhorn used an account date basis to formulate its loss reserves, Delta Holdings was unaware of certain facts that could have altered its view of Elkhorn as an acquisition." Among these, suggested the court, were the "depth of Norton's knowledge" of the account-date problem and its effect on loss data from older account years; "whether Norton produced truly representative [broker] statements [from earlier account years], or whether certain statements were chosen in an effort to mollify [Peat Marwick's account-date] concerns"; and the circumstances surrounding "the non-disclosure of the Tillinghast documents." The district court also rejected Distillers' statute-of-limitations defense to Delta's claim under Section 12(2) of the Securities Act, reasoning that, under the adverse interest exception to the law of agency, Norton's knowledge may not have been attributable to Delta and that material questions of fact existed as to Delta's own knowledge.

Following a bench trial, the district court ruled in Delta's favor, based on (i) Norton's failure to disclose the Tillinghast Reports, which, in the court's view, would have disclosed Elkhorn's $20 million loss reserve deficiency and insolvency to Delta, and (ii) the court's conclusion that Distillers had guaranteed the accuracy of the June 30, 1983 and September 30, 1983 balance sheets' estimates of loss reserves. The district court found that Elkhorn was insolvent at those times, based on the "most credible and compelling explanations" given by Delta's expert witnesses of Elkhorn's conditions on those dates. It further found that Norton knew of Elkhorn's insolvency. This finding was based on Norton's request that Tilling-

hast not calculate actual loss reserve liabilities in the February Report and his concealment of both Tillinghast Reports. The court noted that use of account-date data rather than book-date data understated loss reserve liabilities. However, it found no deception in connection with use of the STREAM software.

The court held that Distillers, through its agents Norton and Joslin, violated Section 10(b) of the Securities Exchange Act and Section 12(2) of the Securities Act, committed common law fraud, breached Elkhorn's promise to give Delta access to Elkhorn's books and records, and breached its warranties of accuracy as to the June 30, 1983 and September 30, 1983 balance sheets. To restore Delta to its pre-purchase position, Judge Keenan rescinded the acquisition and awarded pre-judgment interest on the purchase price running from September 30, 1983. Moreover, because Delta's post-purchase capital contribution reasonably could have been anticipated at the time of the acquisition, and because Kentucky's seizure of the company had resulted in the complete loss of that $6.3 million contribution, the court awarded damages in the full amount of Delta's capital contribution and interest from May 29, 1985, the date Kentucky seized Delta Re's assets. This appeal followed.

DISCUSSION

We briefly summarize our holdings. The contents of the Tillinghast Reports were either not material in the context of this transaction or were disclosed. The February Report contained information on the B-F Method that was well known to actuaries, including those at Conning and Peat Marwick. The projections that might have been made from its worksheets were stale at the latest by December

1982. The substance of the April Report, if not its existence, was disclosed to ARM and Peat Marwick at the earliest opportunity.

We conclude that the district court's finding that Norton knew that Elkhorn was insolvent is clearly erroneous. Disclosure and scrutiny of the February Report might have alerted an actuary to the account-date problem. However, Peat Marwick knew of this problem before the acquisition, and Elkhorn was under no duty to make an independent study of the effect of the use of account dates. Finally, we hold that Distillers did not guarantee the adequacy of Elkhorn's loss reserves estimates.

1. *The District Court's Conclusions Regarding the Tillinghast Reports*

The district court's finding that Norton failed to disclose the February and April 1982 Tillinghast Reports to Distillers and knew of Elkhorn's insolvency was the basis for its conclusion that Delta violated Sections 10(b) and 12(2), committed common law fraud, and breached the agreement to provide access to Elkhorn's books and records. The district court believed the Tillinghast Reports demonstrated Elkhorn's $20 million loss reserves deficiency and insolvency and were concealed for that reason. As noted, the district court found that neither Delta nor its representatives were told of either Tillinghast Report and that this non-disclosure was accompanied by "affirmative misstatements by Elkhorn-Distillers representatives to [Delta's] people." These misrepresentations concern Norton's statements regarding his learning of the B-F Method from Tillinghast. Judge Keenan thus placed great weight on Kaufman's recounting of a meeting with Norton in which Norton casually joked about learning the B-F

Method from Tillinghast "without having a study from them . . . [and] without having to pay for it."

The district court's finding that Norton knew of Elkhorn's insolvency at the time of the acquisition is clearly erroneous. This finding was based on Norton and Joslin's request that Tillinghast not calculate a precise loss reserve figure in the February Report and Norton's subsequent concealment of both Tillinghast Reports. The finding thus dates Norton's knowledge of insolvency as beginning in *October 1981*, when the February Report was commissioned with a request that a loss reserve figure not be calculated, and continuing for some two years until the Delta acquisition. It is not supported by the record.

Assuming Norton could "know" of Elkhorn's insolvency in 1981—given the imprecision of loss reserve estimates, Norton's basic ignorance of actuarial methodology, and the paucity of evidence that Elkhorn was actually insolvent in October 1981—such a finding assumes the existence of a highly sophisticated, even fantastic, plot that has no evidentiary basis in the record. Such a scheme would have to have begun almost a year before there was any discussion with third parties concerning a sale of Elkhorn. It also would have to have involved knowledge of the effect of the use of STREAM software data on loss development triangles.

Based on STREAM data, Norton constructed loss development triangles for December 1982 that showed a relatively negligible loss reserve deficiency. If Norton knew of Elkhorn's insolvency from October 1981 to September 1983, then he would have had to have known of the account-date problem and of the magnitude of its effect on his December 31, 1982 triangles. Such a plot

would have had to rely on the hope that a proposed purchaser learning of the account-date problem would not seek book-date data before going on with the acquisition. Moreover, to succeed, such a scheme would require the cooperation of others at Elkhorn, at least McGurty and Cascio, who would have had to join in the fraud on the purchaser, a firm that was about to become their employer. There is no evidence of such a highly implausible scheme.

The evidence is that STREAM was purchased by Elkhorn in order to computerize its bookkeeping. Based on this record, no one anywhere knew at the time that STREAM would not produce the most reliable data for loss development triangles[3] or, until the events leading to this litigation, ever focused on that problem. As a general bookkeeping software, STREAM had many uses, and there is no evidence that Distillers' purchase of STREAM was anything but innocent. The record indicates that in 1982 reinsurers of Elkhorn's size generally had neither computerized bookkeeping nor an actuary. There is no evidence that Elkhorn's contemplation of a conversion to computerized bookkeeping, which began before delivery of the February Report, ever took the construction of loss development triangles, a novelty at Elkhorn, into account. No suspicion can thus attach to the acquisition of bookkeeping software that was not well-designed for preparing loss development triangles.

The district court did not, of course, find that any such plot existed. Nevertheless, absent such a scheme, Norton cannot be found even to have suspected Elkhorn's in-

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3 The district court's opinion treated the use of account dates as a known alternative to the use of book dates. The actuaries testified at trial, however, that they had never before encountered the use of account dates in loss development triangles.

solvency after he constructed the December 31, 1982 triangles. We therefore conclude that the finding as to his knowledge of insolvency at the time of the acquisition is clearly erroneous.

The fact that Norton did not know that Elkhorn was insolvent at the time of Delta's acquisition did not, of course, release him from a duty to disclose the Tillinghast Reports if they contained material information. Before addressing the materiality of the Tillinghast Reports, we note that the district court's findings concerning the concealment of the Tillinghast Reports are not clearly erroneous. However, because inferences regarding materiality may be drawn from concealment, we summarize the record concerning that concealment.

With regard to the February Report, all witnesses seem to agree that Norton indicated that he had learned of the B-F Method from Tillinghast. Kaufman's testimony that Norton indicated he had learned the B-F Method without having to pay for a study differs only in detail from Norton's story that Joslin ordered only a methodology study without paying for calculations that Elkhorn could do itself. Norton, of course, testified that he mentioned both Reports to Delta's representatives. Ransom, a Conning actuary, testified that, at a meeting in August 1983, Norton said, in Ryan's presence, that Elkhorn had gotten a methodology study from Tillinghast. (The district court rejected Norton's testimony but did not mention Ransom's.) Also, it is undisputed that Norton gave McGurty a copy of the February Report without restriction as to filing or distribution. McGurty testified that he kept the February Report in his files and would have shown it to anyone from Delta who asked for it before or after the acquisition. (The district court did not discuss the undisputed evidence concerning McGurty's copy.) Brewer may

also have received a copy, although the record is unclear. Finally, Norton neither destroyed nor took the February Report with him when he left. Rather, he left it where it would inevitably be found by Delta personnel. Norton may not have disclosed the existence of the Tillinghast Reports, but the record does not suggest any strenuous efforts to conceal them.

With regard to the April Report, it is undisputed that Norton informed Bell and Kaufman in June 1983 of the loss reserve deficiency resulting from the Barrett Treaties and of his attempt to resolve that problem by the purchase of the $10 million loss transfer policy from Continental. Although the existence of the April Report was not mentioned, the substance of its contents was thus disclosed at the first opportunity.

We make these observations concerning the record only to note the frailty of any inference of materiality that might be drawn solely from the apparent concealment. In truth, apart from light they might have shed on the account-date problem, the Tillinghast Reports are red herrings.

The applicable legal standard regarding the materiality of omitted information is whether "there is a substantial likelihood that a reasonable shareholder would consider it important" or "a substantial likelihood that the disclosure . . . would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available." *TSC Industries, Inc. v. Northway, Inc.*, 426 U.S. 438, 449 (1976). We note that the application of this standard in the instant matter concerns the estimate of Elkhorn's loss reserves and the value of the omitted information to Peat Marwick and Conning, firms with actuarial expertise hired to make an indepen-

dent inquiry with regard to the adequacy of those loss reserves.[4] We conclude that as a matter of law the Tillinghast Reports were not material at the pertinent times.

The February Report described the B-F Method in detail, recommended its use, and appended work papers that would assist in applying it to Elkhorn. However, the B-F Method was in the public domain, and it is undisputed that Conning and Peat Marwick were fully aware of it. To the extent the February Report described the B-F Method and contrasted it with the loss ratio method, it would have been no more informative to Conning and Peat Marwick than a discussion of the differences between cash and accrual methods of accounting.

Moreover, the precise calculations that might have been made from the worksheets appended to the February Report would not have been of interest sixteen months later in June 1983. By the very terms of the Report, the February calculations would be stale by December 1982. First, the February Report explicitly stated that treaty-category analysis was superior to the treaty-by-treaty analysis employed on the appended worksheets. Treaty-category analysis was available in late 1982. Second, the data available for constructing the December 31, 1982 triangles was more current by at least a year than the data used in the appended worksheets. An actuary coming upon the February Report would not have bothered to complete the appended worksheets but would simply have assumed that any relevant data contained in the appended worksheets would either be reflected in the December 31, 1982 and June 30, 1983 triangles or supplanted by treaty-

4 We do not address the materiality of documents such as the Tillinghast Reports in the context of a differently structured transaction or less sophisticated investors.

category data. The fact that the later triangles contained account-date data merely underlines the fact that the account-date problem, not the lack of access to the February Report, caused the injury to Delta.

To put the matter another way, if the June 30, 1983 loss development triangles had been based on book data, no one could claim even marginal relevancy for the February Report. Peat Marwick and Conning would have made their respective actuarial judgments based on those triangles. If their opinions were negative, the acquisition would have been halted or proceeded at a lower price. If their opinions were favorable and thus too optimistic, the acquisition would have proceeded with the resultant loss to Delta. In such circumstances, however, no blame could have attached to non-disclosure of the February Report. The sole relevance of the February Report is thus in the light it might have accidently shed on the account-date problem.

The existence of the April Report was similarly immaterial. In applying the B-F Method to the Barrett Treaties, the Report concluded there was a deficiency of $10.9 million in loss reserves with respect to those treaties. However, the problem with the Barrett Treaties was revealed by Norton to Bell of ARM and Kaufman of Peat Marwick at their initial meeting in June 1983. Norton disclosed the purchase of the $10 million loss transfer policy from Continental as his attempt to remedy the deficiency resulting from the Barrett Treaties. The fact that a document contained the facts concerning the problem with the Barrett Treaties was not significant.

The district court appeared to take the view that Norton's opining as to the adequacy of the loss transfer policy as a means of redressing the deficiency resulting

from the Barrett Treaties was a misrepresentation. Even assuming that Norton's opinion was material in the context of independent investigations by professionals with more expertise than he possessed, Delta was not injured. Peat Marwick deemed the Continental arrangement inadequate under GAAP and compensated for it in certifying the reserves. It can hardly be contended, therefore, that material facts concerning the April Report were withheld.

The only significance of the Tillinghast Reports would thus have consisted in whatever light they might have shed on the account-date problem. The February Report might have been significant to an actuary who completed the appended worksheets, if the pertinent loss reserves figures in the February Report could be compared with those in Factor's June 30, 1983 triangles. Whether these figures could be compared is unclear because the worksheets employed treaty-by-treaty analysis while Factor's triangles used treaty-category analysis. If they were comparable—a matter not settled on this record—such an actuary would have noticed the changing numbers—much as the differences between Norton's December 1982 triangles and Factor's June 1983 triangles led her to discover the account-date problem.

The testimony of both Kaufman and Mary Hennessey of Towers Perrin indicated that the materiality of the February Report lay in whatever aid it might have given in illuminating and overcoming the account-date problem. Similarly, at oral argument, counsel for Delta conceded, as he had to, that the Tillinghast Reports contained nothing new so far as the B-F Method was concerned but argued that the disclosure would have revealed the account-date problem. Others, such as Brian, said that actuary reports showing a loss reserve deficiency of $20

million would have been "of interest." That testimony, which assumed that the appended worksheets would have been completed, does not alter the fact that the only pertinent matter that would ultimately have been revealed was the account-date problem. (The section immediately following discusses the relevance of what the February Report would have disclosed concerning the use of account dates.)

However, the argument that the Tillinghast Reports were material because of the light they would have shed on the data on which the December and June triangles were based does not sustain the district court's conclusion regarding their materiality. The district court found that the Tillinghast Reports were material because they facially demonstrated Elkhorn's insolvency, not because they would have revealed the account-date problem. In fact, the court did not find a material misrepresentation or omission concerning the account-date problem.

To reiterate, putting aside the account-date issue, the relevant portions of the February Report were either in the public domain (the B-F Method), stale (1981 treaty-by-treaty figures), or known to Peat Marwick (the Barrett Treaties, Continental transaction). Except for what light might have been shed on the use of account dates, disclosure of these Reports would not have changed events. The district court's theory of the materiality of the Tillinghast Reports, therefore, cannot be sustained, and no liability exists under Section 10(b) of the '34 Act or Section 12(2) of the '33 Act based on that theory. Similarly, the district court's view that Distillers' failure to provide the Tillinghast Reports to Delta breached Distillers' warranty in the Stock Purchase Agreement to provide "reasonable access . . . to all of Elkhorn's . . . work papers, books and records . . . for purposes of review and inspec-

tion" and to "furnish (Delta) with all such reasonable information concerning Elkhorn's affairs as the buyer may request" cannot be sustained. Because the district court's theory of materiality is erroneous and we do not view the warranty as covering immaterial information, we hold that, putting aside the account-date issue, the warranty was not breached.

2. *Distillers' Liability for the Account-Date Problem*

Because of the centrality of the account-date problem to this appeal, we will assess the legal significance of Elkhorn's entire conduct—including but not limited to the non-disclosure of the Tillinghast Reports—concerning the use of account dates.

It is undisputed that Peat Marwick knew, before certifying Elkhorn's reserves, that the Elkhorn loss development triangles were based on account rather than book dates. Norton turned over his December 1982 triangles to ARM and Peat Marwick at the first opportunity in June 1983. It was Factor's comparison of the December triangles with June 30, 1983 triangles that revealed the erroneous nature of the data produced by STREAM. After Factor made that comparison, no one at Elkhorn sought to conceal the cause of the observed discrepancies. Because the use of account dates was disclosed, the only material information not revealed concerned the magnitude of the distortion that use of account dates caused in loss development triangles. However, no one at Elkhorn suggested that the magnitude of the error introduced by the use of account dates was of large, small or any particular dimension. Nor is there evidence that anyone at Elkhorn knew that use of account dates would distort loss development triangles, much less that they knew the direction or size of that distortion.

With regard to the February Report's relevance to the account-date problem, extended scrutiny of the differences between its worksheets and the triangles based on STREAM data might, if the numbers were comparable, have disclosed the magnitude of the distortion. However, that can also be said with regard to scrutiny of the differences between Norton's December 31, 1982 triangles and Factor's June 30, 1983 triangles. (The fact that both Norton and Factor were using STREAM data would not have prevented discovery of the magnitude of the distortion because that magnitude results from the built-in feature of account-date data, as discussed in connection with Figs. 3 and 5.) Finally, and really stretching, the February Report would have revealed that book-date data could be assembled manually. However, Peat Marwick knew that STREAM output was based on raw data in Elkhorn's files but showed no interest in manual retrieval after Factor's discovery of the account-date problem. The Tillinghast Reports thus would have added nothing material to the information about the account-date problem that Peat Marwick had by September 1983.

Nevertheless, given the importance of the account-date problem, we examine Elkhorn's entire conduct regarding that problem in light of relevant legal criteria. We turn first to the question of whether Distillers may be liable under Section 10(b) of the Securities Exchange Act. Liability under Section 10(b)[5] requires a material misrepre-

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5 Section 10(b) reads in pertinent part:

> It shall be unlawful for any person, directly or indirectly . . .
>
> (b) To use or employ, in connection with the purchase or sale of any security . . . any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

15 U.S.C. § 78j(b) (1988).

sentation and a showing of scienter. *See Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976). That test has not been met. For reasons stated, Elkhorn's personnel were ignorant of the ramifications of the account-date problem and of the relevance of the Tillinghast Reports to that problem.

Liability under Section 12(2)[6], however, is more easily established. Again, because the only material information not provided concerned the magnitude of error caused by the account-date problem, the pertinent questions are: (i) whether Distillers' failure to take any position on the magnitude of error was an omission of a fact necessary to make statements that were made not misleading, and (ii) whether, if so, Distillers carried its burden of showing that in the exercise of reasonable care it could not estimate the error's magnitude. We conclude that Distillers prevails as a matter of law on both questions.

Elkhorn personnel did not characterize the use of account dates as causing a distortion of any particular magnitude. We see no basis for concluding that this was

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6 Section 12(2) reads in pertinent part:

> Any person who—
>
> (2) offers or sells a security . . . by means of a prospectus or oral communication, which includes an untrue statement of a material fact or omits to state a material fact necessary in order to make the statements, in the light of the circumstances under which they were made, not misleading (the purchaser not knowing of such untruth or omission), and who shall not sustain the burden of proof that he did not know, and in the exercise of reasonable care could not have known, of such untruth or omission,
>
> shall be liable to the person purchasing such security from him, who may sue either . . . to recover the consideration paid for such security with interest thereon, upon the tender of such security, or for damages if he no longer owns the security.

15 U.S.C. § 77*l*(2) (1988).

a misleading omission. Elkhorn was known to lack actuarial sophistication, the very reason why Delta had insisted on favorable independent opinions from Conning and Peat Marwick as conditions of the acquisition. The silence of the non-actuaries at Elkhorn could not, therefore, have led a professional actuary to believe the problem was trivial.

Moreover, Elkhorn carried its burden of showing that it did not behave unreasonably in failing to probe the magnitude of the account-date problem when Factor inquired as to the reasons for the numbers changing in the loss development triangles. Delta's agents, including two firms with actuarial experience and knowledge far exceeding that of any personnel at Elkhorn, were conducting an independent inquiry into Elkhorn's financial status, with particular concern for the adequacy of its loss reserves. Elkhorn personnel had no reason to expect that their views would be welcome on a matter as to which they were far less knowledgeable than either Conning or Peat Marwick, and might reasonably assume that such questions were for Peat Marwick and Conning to resolve. Elkhorn therefore exercised reasonable care and is not liable under Section 12(2).

For similar reasons, we conclude that Distillers did not commit common law fraud. There was no material misrepresentation by Distillers concerning the account-date problem that was relied upon in any way by Delta. The injury to Delta was caused by its misunderstanding of the problem, which was in no way the result of Distillers' conduct.

Finally, any omission by Elkhorn regarding the magnitude of the account-date distortion did not violate its promise to provide reasonable access to its books and

records. Such a promise cannot extend to matters of which a party is ignorant but which might indirectly be revealed by otherwise immaterial records.

3. *The June 30, 1983 Balance Sheet: Breach of Warranty*

In the Stock Purchase Agreement, Distillers made two representations pertinent to the instant appeal regarding the segregated balance sheet of June 30, 1983. In Section 5(f), Distillers warranted that

> [t]he books and records of Elkhorn are complete in all material respects and have been maintained in accordance with good business and accepted insurance practices and accurately reflect the financial condition and results of the operation of Elkhorn

In Section 5(g), Distillers represented tha

> the June 30th Balance Sheet and related statement of income are complete and accurate in all material respects, were prepared in accordance with Generally Accepted Accounting Principles ("GAAP"), and the June 30th Balance Sheet presents fairly the financial position of Elkhorn as at that date

The district court found Distillers in breach of both warranties because (1) "Elkhorn had incurred substantial loss reserve obligations as of September 30, 1983 which were not disclosed in full," and (2) "[t]he June 30, 1983 Balance Sheet showed a net worth of $18 million rather than Elkhorn's true condition[,] which was insolvency." "Based on information available as of June 30 and September 30, 1983," the court explained, two expert witnesses "demonstrated that the loss reserve liability figures in Elkhorn's balance sheets were understated and the net worth correspondingly overstated." The court further

reasoned that, under New York law, a plaintiff suing for breach of a warranty need not prove express reliance such as a change of position in reliance on a misrepresentation. *CBS, Inc. v. Ziff-Davis Pub. Co.*, 553 N.E.2d 997, 1000 (1990). Instead, any reliance is satisfied by "the express warranty . . . being part of the bargain between the parties." *Id.* at 1001. Relying on this principle, the district court held that Delta had purchased the promise "that warranties contained in the Stock Purchase Agreement were true," and rescinded the Elkhorn acquisition "[i]n view of Distillers' breaches of material portions of the Stock Purchase Agreement."

We do not disagree with the district court's finding, based on the testimony of Delta's expert witnesses, that Elkhorn was insolvent as of June 30, 1983 and that this insolvency was due to the underestimation of loss reserves. *But see* the qualifications stated in Note 2, *supra*. We also do not disagree that the underestimation could have been detected from information available as of that date. Indeed, as noted above, had book-date data been derived manually or STREAM converted to produce such data when the account-date problem was discovered, the insolvency would have been disclosed subject again to the qualifications stated in Note 2, *supra*.

However, we disagree with the district court's view that the warranties quoted constituted a guarantee by Distillers that loss reserve estimates on Elkhorn's books would prove in the future to be substantially accurate. Taking an overview of the deal, Delta refused to go forward without obtaining independent opinions from Conning and Peat Marwick as to, *inter alia*, the adequacy of Elkhorn's loss reserves as of June 30, 1983. Delta also bargained for and received a period of time after the acquisition to reexamine Elkhorn's net worth as of September 30, 1983

and to be entitled to whatever reimbursement Peat Marwick determined.

Delta knew that Elkhorn lacked actuarial expertise, and its initial inquiries revealed a need for a thorough audit and raised serious questions about both Elkhorn's methodology and conclusions as to the adequacy of its loss reserves. Delta's knowledge of Elkhorn's lack of expertise and insistence upon independent actuarial and accounting opinions and post-acquisition arbitration, in an acquisition where the price was set at book value, hardly suggests that Distillers had agreed to guarantee loss reserves. Such an agreement would have been so one-sided so as to be implausible—one in which Distillers could do no better than break even. As the district court viewed the contract, Delta would reap handsome profits if the loss reserves proved excessive. If book value decreased as a result of the underestimation of loss reserves, Delta's losses would be covered by Distillers. An agreement so fraught with down-side risk to Distillers and no hope of gain seems unlikely in light of Elkhorn's actuarial ignorance, of the substantial uncertainty regarding estimates of loss reserves, and of Delta's insistence on favorable actuarial opinions as a condition of the acquisition.

Although the district court relied heavily upon the analysis of Elkhorn's financial condition at relevant dates by Mary Hennessey of Towers Perrin and John Creamer of Arthur Young & Co., Delta never explains what Hennessey and Creamer did that Conning and Peat Marwick could not have done in the course of their July-October inspections of Elkhorn. Nor does the record. Delta thus asks us to construe this contract to allow recovery of the full purchase price based on professional expert testimony in court that disagrees with the contemporaneous pro-

fessional opinions expressed by Conning and Peat Marwick, firms hired by Delta itself to render such opinions.

Turning to the precise terms of the Stock Purchase Agreement, we find no support for that extraordinary view of the Agreement. The language of Section 5(f) warrants the maintenance of Elkhorn's books and records according to accepted practices in the industry so as to reflect accurately its financial condition. There is nothing in that language suggesting that estimated items such as future losses are guaranteed as to future adequacy. What is warranted is that the loss reserves stated have been set aside. Section 5(g) on its face warrants only that the June 30, 1983 balance sheet was consistent with GAAP and does not guarantee the accuracy of estimates of future claims to any extent beyond that required by GAAP.

Moreover, the Agreement contained specific guarantees of balance sheet items that would have been superfluous if Sections 5(f) and (g) guaranteed the accuracy of all estimated items on the balance sheet. For example, Distillers explicitly warranted that "[a]ll material tax liabilities . . . are adequately provided for" and agreed to defend and satisfy liabilities in excess of Elkhorn's tax reserves. Distillers also certified that "the book value of the bond portfolio . . . did not, at August 31, 1983, exceed the market value thereof by more than $1,635,000," thereby minimizing the risk to Delta that Elkhorn's assets were inflated on the June 30 balance sheet. This warranty is significant because, in June 1983, ARM viewed the two greatest risks with regard to the acquisition of Elkhorn as the possible overvaluation of its bond portfolio and the possible inadequacy of its loss reserves, both of which are balance sheet items.

Finally, Section 12, which we set out in the margin,[7] provided Delta with a post-purchase right to challenge the book value of Elkhorn. Under that provision, Delta was allowed to deliver no later than October 17, 1983 its own balance sheet setting forth Elkhorn's financial condition as of September 30, 1983. If Delta's balance sheet showed a net worth in excess of $18 million, Delta would pay Distillers a dividend equal to the excess amount; if it showed a net worth of less than $18 million, Distillers was required either (1) to remit to Delta the amount of the deficit by October 31, 1983 or (2) to submit the valuation

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7 Section 12 provided:

> 12. *Adjustments to the Purchase Price*. No later than October 17, 1983, Buyer shall deliver a balance sheet of Elkhorn as at September 30, 1983 (the "September 30th Balance Sheet"), prepared in accordance with GAAP and on the same basis as used in the preparation of the June 30th Balance Sheet. The book value of all Bonds, Preferred and Common Stocks included in the September 30, 1983 Balance Sheet will be determined by Princeton Financial Systems Inc. and shall be binding on all parties. Seller guarantees to Buyer that the Net Worth of Elkhorn, as at September 30, 1983 shall not be less than $18,000,000.
>
> In the event that the Net Worth of Elkhorn is greater than $18,000,000 as shown on the September 30th Balance Sheet, then Elkhorn shall pay a dividend to the Seller on or before the 28th October 1983 in an amount sufficient to reduce the Net Worth of Elkhorn to $18,000,000 in accordance with Clause 10 hereof.
>
> In the event that the Net Worth of Elkhorn as shown on the September 30th Balance Sheet is less than $18,000,000, then Seller shall pay such deficit to the Buyer at Fort Lee, New Jersey, on or before the 31st of October, 1983, or if such Balance Sheet shall be disputed (as below provided) then payment shall be made promptly after the settlement of such dispute.
>
> In the event Seller disputes the September 30th Balance Sheet, Seller shall advise the Buyer not later than the 25th October, 1983 and any such dispute, if not resolved promptly between the parties, shall be resolved by the opinion of Peat, Marwick, Mitchell & Co., which said opinion shall be final and conclusive and binding on all parties hereto.

dispute to Delta's outside accountant, Peat Marwick, for "final and conclusive and binding" resolution. Thus, Section 12 afforded Delta a binding, post-purchase opportunity to arbitrate book value, and thus the adequacy of Elkhorn's loss reserves, before Delta's chosen accountant.

We cannot, therefore, stretch the basic accounting warranties of Section 5 to serve as guarantees of the future adequacy of loss reserves without upsetting the allocation of risk deliberately established by the Stock Purchase Agreement. It is axiomatic that "[t]he term 'generally accepted accounting principles' should not be interpreted *in vacuo* but only in relation to the particular type of business involved." *Pittsburgh Coke & Chemical Co. v. Bollo*, 560 F.2d 1089, 1092 (2d Cir. 1977). Likewise, the phrase "complete and accurate in all material respects" should not be divorced from the commercial context in which it is used. The presence of unequivocal warranties as to the adequacy of Elkhorn's tax reserves and the market value of its bond portfolio—items included in the June 30 balance sheet—strongly indicate that the parties viewed Section 5 as being no more than what its language says, a warranty as to accounting accuracy and regularity, not a blanket guarantee of net worth.

Under New York law, "[a] specific provision will not be set aside in favor of a catchall clause." *William Higgins & Sons, Inc. v. State of New York*, 231 N.E.2d 285, 286 (1967). "Definitive, particularized contract language takes precedence over expressions of intent that are general, summary, or preliminary." *John Hancock Mutual Life Ins. Co. v. Caroline Power & Light Co.*, 717 F.2d 664, 669 n.8 (2d Cir. 1983) (applying New York law).[8] If either Section

8 In its summary judgment decision in the instant matter, the district court described Section 12 of the Stock Purchase Agreement as "clear and unambiguous"—"guarantee[ing] the net worth of Elkhorn" but

5 or Section 12 of the Stock Purchase Agreement is a guarantee of Elkhorn's net worth and creates rights of challenge to the June 30 balance sheet, Section 12 is obviously the more "specific provision" and Section 5, by comparison, the "catchall clause." *William Higgins & Sons*, 231 N.E.2d at 286.

For these reasons, we believe Sections 5(f) and (g) warranted only that (i) no material item had been omitted; (ii) each item was accurately described, *e.g.*, amount of loss reserve; and (iii) the June 30 balance sheet was prepared in accordance with GAAP. So read, Section 5 neither duplicates other warranties of specific balance sheet items nor undercuts the conditional guarantee and right of challenge provided by Section 12. So read, Section 5 affords Delta a right to challenge the propriety of Distillers' accounting under GAAP on the June 30 balance sheet, whereas the right to challenge loss reserve estimates otherwise consistent with GAAP is subject to the terms and remedies enunciated in Section 12.

Because the district court believed that Sections 5(f) and (g) guaranteed that the June 30 balance sheet statement of loss reserves would, with an excess of $18 million, be adequate to cover future claims, it never explained how—or even whether—Elkhorn's June 30 balance sheet ran afoul of GAAP. Although the district court found that "the actuarial analyses of Towers Perrin, as presented by Mary Hennessey, and the conclusions of Arthur Young & Co., as presented by John Creamer, were

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"intertwined with procedures and remedies lucidly set forth within that section," namely the exchange of a post-purchase balance sheet and submission of any dispute to binding arbitration. Given this earlier ruling, with which we agree, the district court's later reading of Section 5 as providing a second, and unqualified, guarantee of the balance sheet seems anomalous.

the most credible and compelling explanations concerning Elkhorn's true financial picture as of June 30," Section 5 never warranted that the June 30 balance sheet represented the "most credible and compelling" portrayal of Elkhorn's "true financial condition." The district court's findings and conclusions thus have no relevance to the question of whether the June 30 balance sheet conformed with GAAP. We turn now to that question, the most easily resolved issue in this complex matter.

Delta does not claim, and the district court did not find, that the June 30 balance sheet was incomplete or inaccurate in any respect other than that its estimated loss reserves were too low. Peat Marwick certified that balance sheet as well as the September 30, 1983 balance sheet as consistent with GAAP. Delta's witnesses testified to no gaps or inaccuracies in the data base provided by Elkhorn's records, on which the June 30, 1983 balance sheet entries were based, apart from STREAM's failure to afford separate retrieval of book dates. However, Sections 5(f) and (g) do not warrant easy computerized preparation of loss development triangles, and no claim is made that the raw data in Elkhorn's files regarding book dates was inaccurate. GAAP does not require actuarial review of loss reserves estimates, much less the use of loss development triangles.

With regard to the estimate of loss reserves, Delta does not even argue that the actuarial method employed by Elkhorn—the loss ratio method—was inherently unreasonable or inconsistent with GAAP. As our extended discussion *supra* noted, GAAP does not require that reinsurers use any particular actuarial method, and the loss ratio method was recognized as acceptable.

Nor can it be maintained that the specific loss ratio employed by Elkhorn—sixty-five percent or the ceding company's recommendation—was at the time viewed by professionals as so overly optimistic as to violate GAAP. Delta presented no such evidence at trial and, had that been the case, Conning and Peat Marwick, both of which were fully aware of Elkhorn's methodology of estimating loss reserves, would have concluded their studies in less than an hour. As noted, loss reserves are not like a debt with fixed payments of principal and interest. Informed guesswork is an accepted basis for determining such reserves, and Elkhorn's books were based on such guesswork.

We therefore reverse.

UNITED STATES COURT OF APPEALS

FOR THE SECOND CIRCUIT

DOCKET NUMBER 90-7528

At a stated term of the United States Court of Appeals for the Second Circuit, held at the United States Courthouse, in the City of New York, on the 27th day of November, one thousand nine hundred and ninety-one.

DELTA HOLDINGS INC.,

Plaintiff-Appellee,

v.

NATIONAL DISTILLERS AND CHEMICAL CORP.,

Defendant-Appellee.

A petition for rehearing containing a suggestion that the action be reheard in banc having been filed herein by Appellee Delta Holdings.

Upon consideration by the panel that heard the appeal, it is

Ordered that said petition for rehearing is DENIED.

It is further noted that the suggestion for rehearing in banc has been transmitted to the judges of the court in regular active service and to any other judge that heard the appeal and that no such judge has requested that a vote be taken thereon.

ELAINE B. GOLDSMITH
Clerk

UNITED STATES DISTRICT COURT

SOUTHERN DISTRICT OF NEW YORK

85 Civ. 3439 (JFK)

DELTA HOLDINGS, INC.,

Plaintiff,

—against—

NATIONAL DISTILLERS AND CHEMICAL CORPORATION,

Defendants.

FINDINGS OF FACT and
CONCLUSIONS OF LAW

APPEARANCES:

For Plaintiff:

Kaye, Scholer, Fierman, Hays & Handler
New York, New York
Of Counsel: David Klingsberg, Esq.
Alan F. Goot, Esq.
Michael Braff, Esq.
Steven Hirsch, Esq.

For Defendants:

Breed, Abbott & Morgan
New York, New York
Of Counsel: Joseph P. Dailey, Esq.
Joseph Tesoriero, Esq.
Loren Selznick, Esq.

JOHN P. KEENAN, *United States District Judge*

I. FINDINGS OF FACT

THE PARTIES

Plaintiff, Delta Holdings, Inc. ("Delta"), is a corporation organized and existing under the laws of the State of Delaware with its principal place of business in the State of New Jersey. Defendant National Distillers and Chemical Corporation ("Distillers") is a corporation organized and existing under the laws of the Commonwealth of Virginia, with its principal place of business at 99 Park Avenue, New York, New York. Distillers is a diversified manufacturing company, having annual net sales in 1984 of about $2.4 billion. It is engaged in the business of producing chemicals and liquefied petroleum gases. Distillers has also owned and operated companies in the insurance and reinsurance business, including Elkhorn Insurance Company ("Elkhorn"). On January 4, 1988, Distillers changed its name to Quantum Chemical Corporation.

Background

This is an action for alleged breach of contract and fraud committed by defendant in connection with the sale of Elkhorn to Delta on September 30, 1983 for $18 million in cash. Plaintiff seeks recission, return of its $18 million, $6.3 million in consequential damages and interest.

The contract of sale dated September 30, 1983 warranted the accuracy of the June 30, 1983 Balance Sheet of Elkhorn showing net worth of $18 million. Delta further urges that Elkhorn was virtually insolvent as of the end of 1981, that its financial condition was continuing to deteriorate and that Robert Norton, the President of Elkhorn and Assistant Secretary of Distillers, as well as Ramsey Joslin, Chief Financial Officer of Distillers, knew of its precarious financial position and concealed this from Delta and its agents.

This litigation has been the subject of two earlier opinions by this Court dated September 4, 1986 and April 8, 1988.

Besides the breach of contract claims, Delta contends that defendant violated Section 12(2) of the Securities Act of 1933 by making material misrepresentation and omissions in connection with the Elkhorn sale.

Jurisdiction and Venue

The parties have stipulated that this Court has jurisdiction over this action under 28 U.S.C. § 1332(a); 28 U.S.C. § 1331; § 27 of the Securities Exchange Act of 1934, 15 U.S.C. § 78aa; and pendent jurisdiction. Plaintiff and defendant are citizens of different states and the amount in controversy, exclusive of interest and costs, exceeds the sum of ten thousand dollars ($10,000).

Venue is based upon the provisions of 28 U.S.C. 1391(a) in that the claims set forth herein arose in this judicial district; 28 U.S.C. § 1391(b) in that defendant resides in this judicial district; and 28 U.S.C. § 1391(c) in that defendant is a corporation licensed to do and doing business in this judicial district.

Factual Findings

From 1965 to 1972 Elkhorn was engaged in the business of insuring the risks or reinsuring the risks of Distillers. In 1972 Elkhorn expanded and began to underwrite third party risks. By 1983 third party reinsurance had become the major part of Elkhorn's business. (SF 14, 15).[1] Elkhorn was a wholly-owned subsidiary of Distillers until its sale to Delta on September 30, 1983 and Elkhorn was licensed to carry on insurance and reinsurance business in the states of Kentucky and New York. (SF 34, 13). Robert Norton was Assistant Secretary of National Distillers from 1963 until September 1983 and became President of Elkhorn in 1972. (SF 17).

The reinsurance business operates as follows: A primary insurer accepts a risk from an insured in exchange for the

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1 SF stands for Stipulated Fact in the Pre-Trial Order.

payment of a premium. In order to spread the risk of loss from any one policy among several companies, the insurer then transfers ("cedes") a portion of that risk to one or more reinsurers, which accept the risk in exchange for a premium from the ceding company. A reinsurance "treaty" is a contract whereby a reinsurer agrees to accept a prescribed participation in all risks of a certain type or class underwritten by a primary insurer (or another reinsurer) during a stipulated period of time. (SF 22).

Mary Hennessey, a fellow of the American Casualty Actuarial Society who worked for the management consulting firm of Towers Perrin, testified as plaintiff's expert. She pointed out that the largest liability on a reinsurer's balance sheet is the liability established for losses which the reinsurer must pay under its treaties or other reinsurance obligations. This liability is referred to in the industry as the company's "loss reserves." (Tr. 38-45). This was also confirmed by another of plaintiff's experts, John W. Creamer, a partner at Arthur Young. (Tr. 1425-1429).

Under state statutory accounting principles for insurance companies (including those of Kentucky and New York) and under Generally Accepted Accounting Principles ("GAAP"), reinsurers are required to set forth in their financial statements an appropriate loss reserve liability for losses incurred but not yet paid. (DX 672, pp. 7-10).

The required level of loss reserves for a reinsurer is fixed by calculating the amount ultimately to be paid on specific losses which have been reported by the ceding insurance company to the reinsurer but not yet paid. These are called "case reserves." The amount of losses incurred but not reported ("IBNR"), which are anticipated to be reported in the future as determined by accepted actuarial methods must also be calculated. The sum of these two components, i.e., case reserves and IBNR are recognized as liability on the balance sheet of reinsurers in the form of loss reserves. (Tr. 1425-29; Tr. 38-45; DX 672, pp. 7-10). As pointed out in this Court's decision of April 8, 1988, the importance of these loss reserves is profound and the critical nature of loss reserves was known to Distillers and Norton.

In the early 1970's, Norton, who was not an actuary, began to establish the IBNR loss reserves for Elkhorn's casualty business by recording 65% of the earned premiums for casualty treaties and ocean marine, unless the ceding company recommended an IBNR reserve for a particular treaty, in which case Elkhorn would follow the recommendation. The 65% IBNR formula remained in place up to the time of the purchase of Elkhorn by Delta on September 30, 1983. (Tr. 91; McGurty Dep. Tr. 190-92). Elkhorn did not create any IBNR for its property business unless an amount of IBNR was recommended by a ceding company. (Tr. 91, 141).

American Risk Management, Inc. ("ARM") was responsible for day to day management of Delta and later would become similarly responsible for Delta's operating subsidiaries. On March 31, 1983 Delta retained ARM to render management, administrative and advisory services pursuant to a management agreement. (SF 20).

In April, 1983, National Distillers decided to discontinue the third-party reinsurance business of Elkhorn. As a result of that decision, Norton contacted Arthur H. Deters of ARM in his Bermuda office to arrange a meeting. At a subsequent meeting on or about April 6, 1983, Joslin and Norton informed Deters of National Distillers' decision to discontinue Elkhorn's assumed reinsurance business and asked if ARM could assist in any one of three ways: (1) management of an orderly winding down (or "run-off") of Elkhorn's treaties then in force; (2) making private and discreet inquiries as to whether there might be some buyer for Elkhorn's reinsurance business; or (3) proposing to Delta that it purchase Elkhorn's reinsurance business. (SF 19).

On or about May 3, 1983 representatives of ARM and National Distillers met at 99 Park Avenue and agreed to explore the possibility of a sale of the reinsurance business of Elkhorn to Delta for a price of $18 million, assumed to be equal to the book value of the business to be purchased and sold. On June 1, 1983, John J. Ryan, the Chief Financial Officer of ARM ("Ryan") and a lawyer employed by ARM met with Norton, Joslin and Francis Brophy, Vice President and Controller of Distillers, at 99 Park Avenue to discuss the

potential acquisition of Elkhorn by Delta. (SF 26, 27 Tr. 1891).

On June 8, 1983 Norton and Ryan met with representatives of the Kentucky Insurance Department in Frankfort, Kentucky, and advised the Department of a proposal under which Delta would purchase all the outstanding shares of Elkhorn for $18 million dollars, a price equal to the book value of the business to be purchased. (SF 28).

On July 19, 1983, Messrs. Joslin, Brophy, Salisbury, Norton, Reiss, Deters, Ryan and Gunning met at 99 Park Avenue and reached an agreement in principle for the sale of Elkhorn at a book value price of $18 million. Since the book value shown on the June 30, 1983 Elkhorn balance sheet was $26,472,000, the parties agreed at the July 19, 1983 meeting that Elkhorn would segregate the business to be sold to Delta (that was to have a book value of $18,000,000) from business to be retained by National Distillers (principally National Distillers' captive business). (SF 30, 31).

On July 25, 1983 Delta and National Distillers executed a Letter of Intent for the acquisition of Elkhorn which incorporated the terms and conditions agreed to by the parties on July 19, 1983. (SF 33).

In connection with the purchase of Elkhorn by Delta, Conning & Co. ("Conning"), an actuarial firm, prepared a repurchase calculation of Elkhorn's loss reserves as of June 30, 1983 for Delta. (SF 36-40, DX 254). Peat, Marwick, Mitchell & Co. ("Peat Marwick") also preformed a prepurchase audit of Elkhorn's June 30, 1983 Balance Sheet.

On September 28, 1983, the directors of Delta met in Hamilton, Bermuda to consider the Elkhorn acquisition. Prior to the September 28, 1983 Board meeting, ARM distributed a package of materials to the directors of Delta relating to the Elkhorn acquisition. (DX 273). In addition to the materials distributed to the directors in advance of the September 28, 1983 Board meeting, copies of other documents relating to the acquisition were available for inspection by the directors, including a four page extract of the Conning report, a draft of the Peat Marwick audit report and the September 23. 1983 draft of the Stock Purchase Agreement. (SF 46-48).

The closing of the acquisition of Elkhorn by Delta occurred in Hamilton, Bermuda on September 30, 1983. At the closing, the parties executed the Stock Purchase Agreement under the terms of which Delta acquired the shares of Elkhorn from National Distillers on September 30, 1983 for $18 million which was paid in cash by wire transfer. (SF 49-51).

Norton remained as President of Elkhorn and became an employee of ARM, which assumed responsibility for management of Elkhorn on Delta's behalf. Shortly after the purchase, Elkhorn was renamed Delta America Re Insurance Co. ("Delta Re"). (SF 21).

On November 15, 1983 Peat Marwick was retained by Delta to audit the December 31, 1983 financial statements of Delta Re. At the beginning of July 1984, examiners from the Kentucky Insurance Department began a quadrennial examination of the financial condition of Elkhorn as of December 31, 1982. In examining the financial condition of Elkhorn and Delta Re, the examiners from the Kentucky Insurance Department relied on loss development data through July 31, 1984.

After he reviewed the loss development information through July 31, 1984, the lead examiner of the Kentucky Insurance Department, William Barton, preliminarily concluded that the loss reserves of Elkhorn as of December 31, 1982 were deficient by $38 million. Based on this preliminary conclusion, the Kentucky Insurance Department decided also to examine the financial condition of Delta Re as of December 31, 1983, and thereafter.

On May 29, 1985, Delta Re was declared insolvent and placed into rehabilitation under the supervision of the Kentucky Insurance Department by the Franklin County, Kentucky, Circuit Court. Delta Re was placed in liquidation by order of the Franklin County, Kentucky, Circuit Court dated September 15, 1985. (SF 55-60).

It is clear that Elkhorn was insolvent on September 30, 1983, the date of the purchase by Delta. Elkhorn's books and records on September 30, 1983 understated Elkhorn's liability for loss reserves by a substantial and material amount. That

understatement of reserves was not disclosed to Delta before the closing in Hamilton, Bermuda on September 30, 1983. (PX 34, Section 5(q), DX 671, DX 672, Creamer Tr. 1442-1444). As of that date Elkhorn's books showed IBNR of $15,767,000, an amount that was grossly understated. (DX 671, 672).

It is also clear that Elkhorn was insolvent as of June 30, 1983 (DX 671, Tr. 1159-64, 1442-44). On the June 30, 1983 Elkhorn Balance Sheet, which stated Elkhorn's net worth at $18 million (DX 71, p. 3), the amount of IBNR loss reserves was also grossly understated. It showed an amount of $15,847,000 (DX 671, 672), too little by far.

At trial various reports and studies were referred to and testified about concerning the appropriate Elkhorn loss reserves as of June 30, 1983, September 30, 1983 and earlier. There were the so-called Litigation Triangles, the Liquidator Triangles and two reports supplied to Elkhorn by the distinguished actuarial firm of Tillinghast, Nelson and Warren, Inc. ("Tillinghast") in February and April 1982 (PX 7 a and b, PX 19). They all properly concluded that Elkhorn's loss reserves were substantially understated.

The Court finds that the actuarial analyses of Towers Perrin, as presented by Mary Hennessy (DX 672), and the conclusions of Arthur Young & Co., as presented by John Creamer (DX 671), were the most credible and compelling explanations concerning Elkhorn's true financial picture as of June 30, 1983. Their studies relied upon information which existed as of September, 1983 and their opinions are accepted by the Court.

As this court pointed out at page 6 of its April 8, 1988 decision there are two methods of arriving at loss reserve figures in the insurance industry: the book date basis and the account date basis. The book date basis is more conservative, it "reflects the date a loss or premium was received and entered on the books of the reinsurer." The account date basis "reflects the date a loss or premium was reported to the ceding company and not to the reinsurer." Elkhorn used the account date basis in preparing its loss and premium triangles. Various experts testified that the use of account date tri-

angles for standard actuarial calculations results in understated loss development factors, understated loss ratios and understated loss reserves (Tr. 73-85; 792, 3; 1700, 1701; 2308, 09; 2523-28).

The September 30, 1983 Stock Purchase Agreement ("SPA") (PX 34) contained an obligation of Distillers running to Delta in Section 4 thereof to supply Delta "reasonable access to all of Elkhorn's . . . work papers, (and) books and records." Distillers and Norton, who was Elkhorn's President and a corporate officer of Distillers, failed to disclose to Delta the existence and contents of the February, 1982 and the April, 1982 Tillinghast Reports. The February, 1982 Tillinghast study (PX 7A, 7B) concluded that Elkhorn was $10 million underreserved on December 31, 1980 and the April, 1982 Tillinghast Report (PX 19) contained an actuarial opinion that Elkhorn was underreserved by an additional $10.9 million on December 31, 1981. This additional amount related to three reinsurance treaties not included in the February, 1982 Tillinghast Loss Reserve Study. In October, 1981 Elkhorn's President, Norton, *and* Distillers' Chief Financial Officer, Joslin, engaged the Tillinghast actuarial firm because they realized that the 65% IBNR formula (p. 6 *supra*) employed by Elkhorn was "not a good system" (Tr. 98, 99) and was not "state of the art." The testimony established that the study by Tillinghast was the first analysis of Elkhorn loss reserves by a professional actuary. (Tr. 1010-14, 1035-38).

Greg Leonard, a Tillinghast actuary, proposed on or about October 12, 1981 to Joslin and Norton in writing (PX 6A) a calculation of Elkhorn's required loss reserves, but Norton and Joslin rejected this suggestion. The Court concludes that their reason not to accept the Leonard suggestion was that it would record that Elkhorn's loss reserves were seriously understated. (Tr. 106-107; 1009-39).

When Norton received the first Tillinghast Report, "The Elkhorn Insurance Company-Loss Reserve Study," (PX 7A, 7B) ("Loss Reserve Study") it contained a series of recommendations. Norton failed to carry out important recommendations made by Tillinghast:

(1) He ignored the Tillinghast recommendation to increase IBNR loss reserves from 65% to 80% (Tr. 113, 122, 123) and

(2) He did not implement the Tillinghast recommendation to establish IBNR reserves for property business.

Although Norton did speak to Mr. McGurty, Elkhorn's controller, about the $10 million loss reserve estimated by Tillinghast (Tr. 114-118), there is nothing in the record to indicate that Elkhorn took any action to rectify the problem. Moreover, although Price Waterhouse was doing accounting auditing work for Elkhorn at the time of the receipt of the Loss Reserve Study, Norton did not tell Price Waterhouse of the Tillinghast Report.

There were three treaties, the "Barrett Treaties" which had been excluded from the first Tillinghast Report and Norton asked Leonard "would he please take the information that we had and see if he could come up with a method" (Tr. 123) of calculating IBNR for them. In April 1982, Norton received from Tillinghast its "Evaluation of the Loss and LAE Liabilities Associated with the Barrett Treaty Co." (PX 19). Tillinghast calculated that Elkhorn was liable for $13.2 million of IBNR reserves for the three treaties as of year-end 1981. (PX 19, p. 4). Norton knew that Elkhorn carried only $2.3 million of IBNR reserves for the three treaties, and Norton also knew that the second Tillinghast Report calculated they should carry reserves of $13.2 million). The report concluded that Elkhorn's loss reserves on the "Barrett Treaties" were deficient by an additional $10.9 million. (Tr. 426).

Norton failed to increase Elkhorn's loss reserves for the three treaties to cure the loss reserve deficiency demonstrated by the second Tillinghast Report (Norton Tr. 127) nor did he report this additional deficiency to Price Waterhouse, National Distillers' auditors, nor did he supply them with a copy of the report on the "Barrett Treaties." (Tr. 127).

Taken together, the two Tillinghast Reports concluded that the Elkhorn loss reserves were some $21 million understated at the end of 1981. This was a sum that "was just about

Elkhorn's net worth as of December 1981" (Tr. 1211) and as Mary Hennessey put it Elkhorn was "skirting the edge of insolvency in 1981." (Tr. 1211).

A fair reading of Norton's testimony (Tr. 96-98, 167-170) and certain exhibits (PX 11, 28, 30) discloses that Norton and other top executives of Distillers knew very well that Elkhorn's business was going sour from 1980 through June 1983. In spite of all these adverse business conditions of which high Elkhorn management was aware, dividends to Distillers were declared by Elkhorn at the end of 1981 and 1982 in the amounts of $3/4 million and $1 million, respectively.

From May 3, 1983 until the closing in Bermuda on September 30, 1983 there were discussions, negotiations and meetings between Distillers and Delta representatives concerning Delta's acquisition of Elkhorn. (S.F. 26, 27, 30, 33, 50, 51).

From June through September, 1983 Norton met with representatives of ARM, Peat Marwick and Conning to discuss the sale, Elkhorn's financial situation and its loss reserves. (Tr. 142 and *cf.* p. 7 and 8 *supra*). Neither Norton nor, so far as the Court can glean from the voluminous trial record, anyone else from Elkhorn or Distillers ever told anyone at "Delta, Peat Marwick or Conning that (Norton) had a written report by an actuary containing calculations of ultimate losses for Elkhorn's assumed reinsurance business" or "a report containing premium development factors from an outside actuary for Elkhorn's assumed reinsurance business." (Tr. 148). Further, they were never told of the Tillinghast recommendations about the expected loss ratios Elkhorn should have used in calculating loss reserves (Tr. 149) nor were they given the second Tillinghast Report concerning the Barrett Treaties which found the $10.9 loss reserve deficiency. (Tr. 142, 143).

Likewise, Joslin, Distillers' Chief Financial Officer, who participated in meetings with ARM people relative to Delta's acquisition of Elkhorn never told anyone on the buyer's side about the Tillinghast Reports or studies. (Tr. 1044, 1045).

Besides the numerous failures on the part of Norton and Elkhorn to make disclosures to ARM and Delta outlined

above, p. 12 *et seq.*, there were actual affirmative misstatements by Elkhorn-Distillers representatives to plaintiff's people. On June 1, 1983 John Ryan, President of ARM, was at a meeting in National Distillers' offices after which he and Norton went to Norton's office in the same building and Ryan "asked him if he had any audited statements or actuarial reports on Elkhorn and they informed me there was had [sic] never been a separate audit or an actuarial study on on [sic] Elkhorn." (Tr. 351). Apparently later in June of 1983 Allan Kaufman, a fellow of The Casualty Actuarial Society, who then had partnership status at Peat Marwick visited Norton at Elkhorn's offices and in a discussion with Norton about the technique he used in establishing loss reserves Norton told him

> "how he had learned about the Bornhuelter-Ferguson technique (a method of calculating loss reserves). He [Norton] told me [Kaufman] he had learned that through either a seminar or a visit, maybe both, from Tillinghast, the actuarial firm.
>
> In the course of that discussion, he told me that he joked that he had gotten that information *without having a study from them* but that he had gotten it without having to pay for it, but he learned the technique and he was applying it as his reserve analyses." (Tr. 758-759) (emphasis added).

The Court credits this Kaufman testimony and rejects Norton's version that he told Kaplan "we had a method study performed by Tillinghast." (Tr. 270). The weight of the evidence surrounding all aspects of the Tillinghast study and reports stamps Norton as someone who is not to be believed on the subject and who sought to hide from all outsiders the contents of the Tillinghast Reports and the fact that a study was performed. Norton's testimony that he informed ARM, Peat Marwick and Conning that he "had a methodology study" from Tillinghast (Tr. 147), is contrary to the weight of the believable evidence. (Kaufman Tr. 760-62; Ryan

Tr. 351, 358-61, 379; Reiss Dep. Tr. 278-79; Ransom Dep. Tr. 144-45).

In any event the first Tillinghast Report of February 1982 was more than a "methodology study" and the second Tillinghast Report calculated Elkhorn's required reserves for three specific treaties which had an additional $10.9 million loss reserve deficiency over and above the $10 million deficiency demonstrated by the February report. The second Tillinghast Report had nothing to do with "methodology."

The defense effort to suggest that the "continental transaction" cured the IBNR deficiency on the Barrett treaties and that Norton believed this (Defense Proposed Findings of Fact 128-137) is not supported by the credible evidence. (Tr. 179-192; 796-798; 1954-1956).

On September 23, 1983, Norton signed a letter for Peat Marwick in connection with Peat Marwick's pre-purchase audit (PMMX1). It stated that, "We have made available to you . . . [all] financial records and related data." (Tr. 158-61). That statement was false in view of Norton's failure to inform Peat Marwick of the Tillinghast Reports and make them available to Peat Marwick.

Further, Norton falsely represented to Peat Marwick that Elkhorn's June 30 and September 30, 1983 balance sheets were a fair representation of Elkhorn's financial condition on those dates (PMMX1, DX 182).

On September 30, 1983, Norton and Joslin signed the Stock Purchase Agreement (PX 34) on behalf of Elkhorn and Distillers. It contained false representations by Distillers regarding access to Elkhorn's records (Section 4), the accuracy of those records (Section 5(f)) and Elkhorn's financial condition (Sections 5(g) and 12) and Norton knew the representations were false. Norton knew that Elkhorn was nearly insolvent at the end of 1981 and that this information was obviously material and was not disclosed to Delta before the purchase.

The Court concludes that Delta understandably relied on Distillers' false representations.

After the purchase, Norton remained as President of Delta Re, the new name for Elkhorn. (Tr. 161-162). He still did not

reveal the existence of the Tillinghast Reports to his new employer ARM or to anyone at Delta Holdings (Tr. 162-63) and he kept them in his private office at Delta Re's new offices. (Tr. 177, 178). This was in spite of the fact that during the spring of 1984 Norton met with Peat Marwick representatives concerning a loss reserve deficiency and attended an April 4, 1984 Delta Holdings board meeting where the subject of loss reserves was discussed. (Tr. 162).

In July, 1984 special examiners from the state of Kentucky began to examine the financial condition of Elkhorn as of the end of 1982 and by September, 1984 Norton learned from Mr. Barton of the Kentucky Insurance Department that Elkhorn apparently had a loss reserve deficiency of $30 million as of the end of 1982. (Tr. 163). Barton told Norton "that he intended to call in the actuarial firm of Tillinghast, Nelson and Warren in order to perform actuarial calculations to determine Elkhorn's correct loss reserves as of the year-end 1982." (Tr. 164). Although Norton realized that this was the same firm that supplied the two reports to him in 1982 he "didn't talk to Mr. Barton about the Tillinghast reports at all." (Tr. 164).

Norton resigned from Delta Re and ARM on September 14, 1984 without ever telling the Kentucky examiners or anyone at ARM or Delta Holdings about the 1982 Tillinghast Reports. (Tr. 165). In late November 1984 John Ryan, who had replaced Norton as President of Delta Re, found the February 1982 Tillinghast Report in the credenza behind, what had been, Norton's desk. The second Tillinghast Report was not found until early January 1985. (Tr. 380).

The Kentucky Insurance Department found that Elkhorn was insolvent at year-end 1982 and at all times thereafter. (PX 38, PX 117, PX 118, PX 119). As a result of this finding, the Kentucky Insurance Department seized all the assets of Delta Re in May, 1985. Delta Re was placed in liquidation by order of the Franklin County Kentucky Circuit Court. (SF ¶¶ 59-60; PX 208, PX 210).

Besides having paid $18 million for the stock of the insolvent Elkhorn Insurance Company, Delta contributed some $6.3 million to Elkhorn after the acquisition. (Tr. 375, 1546).

Conclusions of Law

Sections 5(f) and 5(g) of the Stock Purchase Agreement of September 30, 1983 contained certain warranties. They read as follows:

Section 5(f)

> [t]he books and records of Elkhorn are complete in all material respects and have been maintained in accordance with good business and accepted insurance practices and principles and accurately reflect the financial condition and results of the operation of Elkhorn.

Section 5(g)

> [t]he June 30th [1983] Balance Sheet and related statement of income are complete and accurate in all material respects, were prepared in accordance with Generally Accepted Accounting Principles ("GAAP"), and the June 30th Balance Sheet presents fairly the financial position of Elkhorn as at that date.

Distillers breached these warranties and Delta has proven these breaches by a fair preponderance of the credible evidence.

The books and records of Elkhorn were not "complete in all material respects" nor were they "maintained in accordance with good business and accepted insurance practices and principles" nor did they "accurately reflect the financial condition . . . of Elkhorn."

The June 30, 1983 Elkhorn Balance Sheet was not "complete and accurate in all material respects" and did not "present[ ] fairly the financial position of Elkhorn as at that date." Elkhorn had incurred substantial loss reserve obligations as of September 30, 1983 which were not disclosed in full to Delta before the closing date. The June 30, 1983 Balance Sheet showed a net worth of $18 million rather than Elkhorn's true condition which was insolvency.

Moreover, the Stock Purchase Agreement, Section 4, Distillers promised to provide Delta

> "reasonable access . . . . to all of Elkhorn's assets, properties, work papers, books and records, and contracts for purposes of review and inspection, and (Distillers) shall upon request furnish (Delta) with all such reasonable information concerning Elkhorn's affairs as the buyer may request."

Delta has proven by a fair preponderance of the evidence that Distillers breached this obligation by concealing the two Tillinghast Reports and not mentioning their existence to plaintiff or its agent.

Based on information available as of June 30 and September 30, 1983, Mary Hennessy of Towers Perrin and John Creamer of Arthur Young demonstrated that the loss reserve liability figures in Elkhorn's balance sheets were understated and the net worth correspondingly overstated. Distillers is in breach of its warranty regarding Elkhorn's June 30, 1983 balance sheet.

Distillers' argument that Delta has not adequately demonstrated reliance on the representations made in the express warranties of the Stock Purchase Agreement is without merit. It is now settled in New York that a plaintiff suing for breach of an express warranty need not prove reliance in the manner required in "a tort action based on fraud or misrepresentation—i.e., a belief in the truth of the representations made in the express warranty and a change of position in reliance on that belief." *CBS, Inc. v. Ziff-Davis Pub. Co.*, slip op. at 7 (N.Y. Ct. App. April 3, 1990). The plaintiff need only prove that it relied "on the express warranty as being a part of the bargain between the parties." *Id.* at 9. Here, it cannot be seriously urged that Delta did not believe that it was purchasing Distillers' promise that the warranties contained in the Stock Purchase Agreement were true. Delta has more than adequately proven reliance on the express warranties.

In view of Distillers' breaches of material portions of the Stock Purchase Agreement, Delta is entitled to rescission. It has the right to be restored to the position it occupied before

signing the Stock Purchase Agreement. *Lipsky v. Commonwealth United Corp.*, 551 F.2d 887, 895-898 (2d Cir. 1976).

In this case, rescission means that Distillers must return to Delta the $18 million which Delta paid to Distillers for the Elkhorn stock and must pay Delta interest from September 30, 1983, the date of the sale. Delta must return to Distillers the Elkhorn stock.

As was pointed out *supra*, p. 20, the record reveals that Delta also made a capital contribution to Elkhorn of some $6.3 million. The Court concludes that the loss of that capital contribution was a foreseeable consequence of Distillers' breach. When the Kentucky Insurance Department seized all of Delta Re's assets on May 29, 1985 (PX 208, Tr. 375, 1546, 47), the $6.3 million was gone. This loss was something "which the parties could reasonably have anticipated at the time the contract was entered into." *Spang Industries, Inc., Fort Pit Bridge Division v. Aetna Casualty and Surety Co.*, 512 F.2d 365, 368 (2d Cir. 1975).

In its Summary Judgment decision of April 8, 1988 at p. 19, the Court ruled as follows:

> "The duty under the federal securities laws to disclose all material facts necessary to make other statements fair, 'is not discharged merely by giving the purchaser access to company records and letting him piece together the material facts if he can.' *Metro-Goldwyn-Mayer, Inc. v. Ross*, 509 F.2d 930, 933 (2d Cir. 1975). The securities laws contemplate investors having 'full access' to material information." *Hirsch v. duPont*, 553 F.2d 750, 763 (2d Cir. 1977).

Distillers well knew that the two Tillinghast Reports "would be material to any reasonable, prudent investor who was contemplating buying" Elkhorn stock. *American General Insurance Co. v. Equitable General Corp.*, 493 F. Supp. 721, 738 (E.D. Va. 1980). Distillers violated 15 U.S.C. § 771 and § 10(b) of the Securities Exchange Act, 15 U.S.C. § 78j as well as Rule 10b-5 promulgated thereunder. It utterly failed to live up to its duty under the federal securities laws by fail-

ing to supply Delta with the Tillinghast Reports and is guilty of common law fraud.

Delta is also suing under § 12(2) of the Securities Act of 1933 which has a one-year statute of limitations. Distillers urges that since the lawsuit was not commenced for 20 months after the sale that the § 12(2) cause of action should be dismissed. However, Norton's fraudulent concealment of the Tillinghast Reports continued from the time of the sale on September 30, 1983 until he suddenly resigned on September 14, 1984 from Delta Re and ARM without ever telling anyone at Delta Holdings or ARM of their existence. This was after he had learned from Mr. Barton of the Kentucky Insurance Department of the $30 million loss reserve deficiency as of year end 1982 (p. 19 *supra)*. The February 1982 Tillinghast Report was not found until late November 1984 and the second Tillinghast Report was discovered in January 1985. Suit was brought in May 1985. Distillers' argument that McGurty, Elkhorn's controller, and Hugh Brewer, former Vice President of Elkhorn, had sufficient knowledge to warrant the 12(2) claim to be defeated on Statute of Limitations grounds is without merit. Neither of them were involved in calculating Elkhorn loss reserves nor were they involved in the 1983 negotiations regarding the sale of Elkhorn to Delta. The Court concludes that the s 12(2) claim was timely filed.

By virtue of Distillers' omissions and misrepresentations regarding the Tillinghast Reports and the material contained in them, Delta was deprived of the material information required by § 12(2). It is quite clear that there is "a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having altered the 'total mix' of information made available." *TSC Industries v. Northway*, 426 U.S. 438, 449 (1976).

Rescission of the sale of securities to Delta is ordered under § 12(2) of the Securities Act.

CONCLUSION

The sale of September 30, 1983 is ordered rescinded. Plaintiff is awarded a total of $24.3 million in damages plus interest.

SO ORDERED.

Dated: New York, New York
April 10, 1990

JOHN F. KEENAN
U.S.D.J.

Supreme Court, U.S.
FILED
MAR 25 1992
OFFICE OF THE CLERK

(2)

No. 91-1361

IN THE

Supreme Court of the United States

OCTOBER TERM, 1991

DELTA HOLDINGS, INC.,

Petitioner,

– against –

NATIONAL DISTILLERS AND CHEMICAL CORPORATION,

Respondent.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF IN OPPOSITION TO WRIT OF CERTIORARI

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Corporate Disclosure Statement

Respondent National Distillers and Chemical Corporation makes this statement pursuant to Rule 29.1 of the Rules of the Supreme Court. On January 4, 1988, National Distillers and Chemical Corporation changed its name to Quantum Chemical Corporation. Respondent has no parent corporation and has the following subsidiary or affiliate companies (excluding wholly-owned subsidiaries):

Domestic Companies	State of Incorporation
Atlantic Energy, Inc.	Delaware
Fallon Propane and Butane Company	Nevada
Petrolane Incorporated	California
Petrolane Finance Corporation	Delaware

Foreign Companies	Country of Incorporation
Cue Insurance Limited	Bermuda
Quantum Petrochemical Corporation Ltd.	England
Petrolane Offshore Limited	Bermuda
Northwest L.P.G. Supply Ltd.	Canada

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1991

No. 91-1361

DELTA HOLDINGS, INC.,

Petitioner,

– against –

NATIONAL DISTILLERS AND CHEMICAL CORPORATION,

Respondent.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF IN OPPOSITION TO WRIT OF CERTIORARI

National Distillers and Chemical Corporation, now known as Quantum Chemical Corporation ("Quantum"), opposes the Petition for a Writ of Certiorari filed by Delta Holdings, Inc. ("Delta Holdings"). The Petition has misstated the decision of the Court of Appeals and the issues that would properly be before this Court if certiorari were granted. The controversy turns on its own facts and does not raise any serious issues under the federal securities laws.

ADDITIONAL OPINION BELOW

The summary judgment decision of the district court, which was not appended to the Petition For Writ Of Certiorari, is reported at [1987-1988 Transfer Binder] Fed.Sec.L.R. ¶ 93,700 (S.D.N.Y. April 8, 1988).

Statement Of The Case

A. *The Transaction.*

This action arose out of the sale of the Elkhorn Re Insurance Company ("Elkhorn"), a casualty reinsurer owned by Quantum, to Delta Holdings on September 30, 1983 for $18 million. The sale followed four months of face-to-face negotiations and a detailed investigation of the loss reserves and financial condition of Elkhorn by a team of experts hired by Delta Holdings, including American Risk Management, Inc. ("ARM"), Peat, Marwick & Mitchell ("Peat Marwick") and Conning & Company ("Conning").

The terms and conditions of the Elkhorn sale were set forth in a Stock Purchase Agreement. Under § 5(g) of the Agreement, Quantum warranted that a June 30, 1983 balance sheet of Elkhorn was complete and accurate, prepared in accordance with generally accepted accounting principles ("GAAP"), and fairly presented the financial position of Elkhorn. Under § 12 of the Agreement, the parties agreed that *after* petitioner acquired control on October 1, 1983, it would prepare a September 30, 1983 balance sheet which would be used to adjust the $18 million purchase price paid at the closing. Quantum guaranteed in § 12 that the net worth shown on the September 30, 1983 balance sheet would not be less than $18 million and, if it were, agreed to pay any deficiency by October 31, 1983. The parties further agreed that if a dispute arose concerning the net worth of Elkhorn as of September 30, 1983, it would be promptly submitted to Peat Marwick for "final and conclusive and binding" arbitration.[1]

The September 30, 1983 balance sheet *prepared by petitioner* after the sale showed a net worth of $18 million, as did a June 30, 1983 Pro Forma Statement of Net Assets audited by Peat

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[1] § 12 of the Stock Purchase Agreement is set forth in Note 7 of the Court of Appeals opinion. See Appendix to Petition For Writ Of Certiorari ("P.App.") at 47a.

Marwick before the sale. In the spring of 1984, another balance sheet was prepared and audited by Peat Marwick showing that Elkhorn, which had changed its name to the Delta America Re Insurance Company ("Delta Re"), had a net worth of $19.2 million as of December 31, 1983.

After operating for twenty months under the management of petitioner, Delta Re was declared insolvent by the Kentucky Insurance Department. Delta Re was a victim of the worst downturn in the reinsurance market since 1906, the year of the San Francisco earthquake. More than 90 reinsurers were forced out of business as the result of overcapacity in the industry and unexpected claim development on policies written in previous decades. Delta Re was placed in rehabilitation on May 29, 1985 and in liquidation on September 15, 1985. The present action ensued.

B. *The Proceedings Below.*

The complaint filed by petitioner in the Southern District of New York in 1985 claimed, among other things, breaches of § 5 and § 12 of the Stock Purchase Agreement and violations of the federal securities laws. Underlying the claims were the allegations, *first*, that Elkhorn was insolvent at the time of the sale due to a massive deficiency in the loss reserves; *second*, that the reserve deficiency was concealed by improperly prepared loss development triangles which actuaries use to make reserve estimates;[2] and, *third*, that the President of Elkhorn, Robert Norton, was aware of the alleged deficiency by reason of two actuarial reports prepared in early 1982 by Tillinghast, Nelson & Warren.

In an April 1988 summary judgment decision, the District Court dismissed the claim under § 12 of the Stock Purchase Agreement, ruling that submission to Peat Marwick for "final and conclusive and binding" resolution by October 31, 1983 was the "exclusive remedy" for resolving disputes concerning the net

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[2] Loss development triangles are computer-generated summaries of reported claim information. See P.App.7a.

worth of Elkhorn at the time of the sale.[3] The Court refused to dismiss the breach of warranty and securities law claims, holding that a trial was required to determine if there was any deception relating to the loss development triangles or any concealment of material information during the preacquisition investigation (R.App. 13-14).

After a six-week bench trial in 1988, the District Court ruled on April 10, 1990 that Quantum breached the accounting warranties in § 5 of the Stock Purchase Agreement by failing to disclose a substantial reserve deficiency at the time of the sale and violated the federal securities laws by concealing the Tillinghast reports. The Court construed § 5 as a warranty on the adequacy of the reserves that provided a second and unqualified right to dispute the net worth of Elkhorn, free of the restrictions of § 12. The Court did not find there was any deception concerning the loss development triangles, nor did it find, with the exception of the Tillinghast reports, any concealment of material information during the four-month investigation. While the Court concluded the Tillinghast reports were material, it never explained what the reports would have added to the two in-depth studies of the reserves conducted by Conning and Peat Marwick before the sale.

On October 1, 1991, the Court of Appeals unanimously reversed the trial court, ruling, among other things, that:

- Quantum did not make any representations in the Stock Purchase Agreement concerning the adequacy of the Elkhorn reserves and the representations it did make concerning compliance with GAAP and accounting regularity were truthful. P.App.44a-51a.

- The construction of the Stock Purchase Agreement adopted by the District Court was "so one-sided so as to be implausible" (P.App.45a) and the decision

[3] See Appendix to this Brief ("R.App.") at 8.

to allow petitioner to dispute the net worth under § 5 was "anomalous" in light of its earlier ruling that § 12 was the exclusive remedy for resolving net worth disputes. P.App.8a-49a n.8.

- The Elkhorn method of establishing reserves was well known within the reinsurance industry, fully disclosed to petitioner prior to the sale, and recognized as acceptable under GAAP. P.App.5a, 20a-21a, 50a-51a.

- The massive reserve deficiency established at trial was developed in the "glow of hindsight" by trial court experts who did nothing after the fact that Peat Marwick and Conning could not have done before the sale. P.App.45a-46a.

- The method of preparing the Elkhorn triangles was disclosed to Peat Marwick before the sale and the injury to petitioner was caused by its own misunderstanding of the triangles, not by the conduct of Quantum. P.App.21a-24a, 39a-43a.

- The Tillinghast reports were "red herrings" that did not contain any material information except what was already in the public domain or disclosed to petitioner before the sale. P.App.34a-39a.

C. *Loss Reserves And Casualty Reinsurance.*

Unlike most businesses, the net worth of a casualty reinsurer is difficult to determine because the largest liability on the balance sheet, the reserve for unpaid claims, is unknown and must be estimated.[4] As the Court of Appeals observed,

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[4] "In most businesses cost information is available before sales are made. In the insurance business, however, the cost of the protection sold cannot be finally

(Footnote continued)

underwriting casualty risks "leads to complex problems of financing and accounting because assumptions of third-party liability risks involves substantial delays or 'tails' in the discovery and reporting of claims" (P.App.4a). For long-tail casualty reinsurers like Elkhorn, the 15 to 20 year delays in the reporting process "inevitably create considerable uncertainty" in establishing reserves (*id.*).

While GAAP requires reinsurers to make a reasonable estimate of reserve liabilities,[5] it neither specifies a precise method of estimating reserves or even requires that an actuary prepare or review the estimates (P.App.5a). All of the actuarial methods require subjective judgments and assumptions that can substantially affect the estimated liability, particularly for incurred but not reported ("IBNR") reserves that are highly "conjectural because they must be calculated without knowing even the number of claims" (P.App.9a). As a result, even the most conservative method

> "relies on assumptions as to future events and conditions, that, if wrong, will lead to substantial errors in the final estimate. Consequently, regardless of the actuarial method used, the preparation of, and reliance upon a net worth calculation in a balance sheet for a casualty risk reinsurer is based in large part upon informed guesswork." *Id.*

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determined until after policies have expired and any losses adjusted. . . .[T]he need to make provision, frequently far in advance of settlement for many casualty losses. . . and for losses which have been incurred but have not been reported, presents a difficult problem. . . ." American Institute of Certified Public Accountants, *Audits of Fire and Casualty Insurance Companies* (1966) (the "Audit Guide") at 34.

[5] The fairness of a balance sheet under GAAP "rests on the reasonableness of the estimates of unpaid losses more than on any other item. However, it is extremely difficult to estimate this element of cost accurately." Audit Guide at 34. See Financial Accounting Standards Board, Statement Of Financial Accounting Standards No. 60, "Accounting and Reporting By Insurance Enterprises" (1982).

D. *The Elkhorn Reserves.*

Elkhorn was a small property and casualty reinsurer incorporated in Kentucky with a staff of twelve employees, including secretaries. The President of Elkhorn, Robert Norton, began his career as an accountant and did not have any actuarial training or experience (P.App.13a). In 1972, Elkhorn began reinsuring casualty risks of third parties, where claims typically take 15 to 20 years to develop and the settlement cost is difficult to estimate. To establish reserves for these risks, Elkhorn used the loss ratio method under which it recorded 65% of earned premiums as IBNR reserves unless a ceding company recommended another ratio. The loss ratio method was a recognized method for establishing reserves under GAAP and was expressly authorized by the Kentucky Insurance Code (P.App.5a).[6]

In October 1981, Elkhorn decided to have its reserving procedures reviewed by Tillinghast, Nelson & Warren. In February 1982, Tillinghast delivered a report that described a particular reserving methodology, recommended its use, and appended worksheets that would assist in applying the methodology as of December 31, 1980, but did not express an opinion on the adequacy of the reserves (P.App.35a). In April 1982, Tillinghast delivered a second report covering the reserves on three canceled reinsurance contracts (the "Barrett treaties"), which it estimated were deficient by $10.8 million. Two months later, Elkhorn purchased a $10 million reinsurance policy to cure the estimated deficiency on the Barrett treaties (P.App.16a).

E. *The Reinsurance Experience And Sophistication Of Delta Holdings.*

Delta Holdings was incorporated in 1982 to engage in a worldwide reinsurance business. Delta Holdings was operated by ARM, a reinsurance management company with a staff of

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[6] *See* Audit Guide at 38. Kentucky permits reinsurers to establish reserves by using a 65% loss ratio for workers compensation risks and a 60% ratio for other risks. Ky.Rev.Stat. §304.6-100(3).

300 specialists that provided financial and underwriting services to reinsurers around the world. In March 1983, ARM raised $24 million for Delta Holdings to enter the reinsurance market by selling stock to 24 clients or affiliates, mostly insurance subsidiaries of Fortune 500 companies.[7]

In addition to ARM, Delta Holdings was advised by two other firms with considerable experience in reinsurance, Peat Marwick, which specialized in auditing insurance and reinsurance companies, and Conning, which provided actuarial services to reinsurers in the United States and Europe. The Board of Directors also had substantial experience in reinsurance, since most of the directors managed the insurance subsidiaries of their parent corporations.

F. *The Preacquisition Investigation.*

At the end of 1982, Quantum decided to withdraw from the insurance business and, in May 1983, began exploring the sale of the assumed reinsurance business of Elkhorn to Delta Holdings for a book value price of $18 million. Prior to speaking with Quantum, ARM had been actively searching for reinsurance acquisitions for Delta Holdings and had already reviewed four other companies where the asking price was more than twice book value. Like many other observers, ARM believed the October 1, 1983 renewal season would mark the beginning of a profitable turnaround for the reinsurance industry.

Petitioner began its investigation of Elkhorn in early June 1983. Recognizing that Elkhorn lacked actuarial expertise, Delta Holdings hired a team of 21 professionals to review the Elkhorn loss reserves and reinsurance business, including five actuaries from Conning and Peat Marwick, six Peat Marwick accountants, three attorneys from a Wall Street law firm, six reinsurance specialists from ARM, and an unknown number of investment bankers from Merrill Lynch. Over the next four months, this

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[7] Shareholders in Delta Holdings included Alcoa, American Cyanamid, Cargil, Celanese, Eli Lilly, Firestone, Kaiser Aluminum, Kellogg, Rockwell International, Scott Paper, Sperry, and Weyerhaeuser.

battery of experts descended upon the Elkhorn offices to pour over the books and records and interview the twelve-man staff. With the exception of the Tillinghast reports, the witnesses who participated in the investigation testified that they were given all the documents and other information they requested during the four-month inquiry.

Shortly after the investigation began, Alan Kaufman, a senior Peat Marwick actuary, was asked to provide petitioner with a preliminary opinion on the Elkhorn reserves. During a June 10, 1983 meeting with Kaufman, Norton explained the data, methodology, and assumptions Elkhorn used to test its reserves, giving Kaufman a copy of worksheets containing his most recent analysis that estimated a $250,000 deficiency as of December 31, 1982. The worksheets revealed exactly how the estimate was derived, including loss ratio and loss development assumptions. When Kaufman asked Norton how he learned to prepare a reserve analysis, Norton said he learned the method from Tillinghast, but did not give Kaufman a copy of the 1982 reports (P.App.33a). Norton also told Kaufman about the poorly-performing Barrett treaties and the $10 million reinsurance policy that was purchased to cover expected losses (P.App.18a-19a). After the meeting, Kaufman advised petitioner that some of the loss ratios selected by Elkhorn appeared to be too low and the reserves were deficient by approximately $5 million.

In July 1983, Conning was retained to perform another review of the Elkhorn reserves. On August 3, 1983, the Conning actuaries met with Norton and were told that Elkhorn established reserves by applying a 65% loss ratio to earned premiums unless a ceding company recommended a different ratio (P.App.20a-21a). Norton also gave Conning a copy of his December 31, 1982 reserve analysis showing the data, methodology, and assumptions he used to test the reserves. In September, Conning submitted a report to petitioner estimating a $1.6 million surplus in the reserves, but cautioned that actual losses "may vary significantly from our estimates since underlying data is quite variable and difficult to project" (P.App.21a). Conning also advised petitioner that the Elkhorn reserves depended on loss ratio assumptions and if different assumptions were used, the estimates could change significantly.

While the actuaries were reviewing the reserves, Peat Marwick spent 327 hours auditing the books and records (P.App.21a). As the audit was drawing to a close, one of the auditors, Amy Factor, noticed that the numbers on the Elkhorn loss development triangles were changing, which she knew was not supposed to happen if the triangles were prepared on what is known as a "book-date" basis. When Factor noticed the changes, she spoke with Norton who said he did not know why the numbers were changing and referred her to his staff (P.App.22a). After speaking with the staff, Factor learned the changes were occurring because the Elkhorn computer software prepared triangles on an "account-date" basis.[8] Factor immediately reported her findings to the Peat Marwick actuaries, who were making an independent review of the reserves as part of the audit. The actuaries knew that account-date triangles would result in an understatement of reserves unless adjusted, but after reviewing their earlier work, concluded that a previous adjustment would be sufficient to correct for any understatement (P.App.22a-24a).[9]

On September 28, 1983 the Board of Directors of Delta Holdings met in Hamilton, Bermuda to consider the proposed acquisition. ARM strongly recommended the Board approve the Elkhorn purchase because the company was being sold at book value, when other reinsurers were selling at twice book, and because Delta Holdings would be in an ideal position to take advantage of an expected turnaround in the reinsurance market. The directors were given the Conning report on the Elkhorn reserves and the Peat Marwick report on the June 30, 1983 balance sheet, which showed a net worth of $18 million. The audit report certified that the balance sheet was prepared in accordance with GAAP and fairly presented the financial position of Elkhorn, noting, however, that the largest item on the balance sheet, the loss reserves, was only an estimate and the

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[8] The nature and significance of "account-date" and "book-date" triangles is described in detail in the Court of Appeals opinion. See P.App.7a-12a.

[9] The Peat Marwick witnesses testified that Conning was also notified of the account-date issue, but Conning denied learning this before the sale (P.App.22a).

actual liability could be higher or lower than the estimate. Peat Marwick also warned petitioner that

> "Insurers who establish claim reserves by applying selected loss ratios to earned premium (such as Elkhorn) often understate IBNR due to management's optimism in making loss ratio selections." P.App.25a.

After hearing from their advisors, the directors voted unanimously to approve the Elkhorn acquisition. Petitioner assumed control of Elkhorn on October 1, 1983 and immediately began preparing the September 30, 1983 balance sheet pursuant to § 12 of the Stock Purchase Agreement. On October 24, 1983, the contract balance sheet was completed by ARM and reviewed by Peat Marwick. It showed a net worth of $18 million. With the parties in agreement over the value of the business, the price adjustment and arbitration provisions of § 12 were never invoked (P.App.25a).

REASONS FOR DENYING THE WRIT

This privately-negotiated securities transaction turns principally on an issue of contract interpretation and the "specific facts" of the Elkhorn sale. *United States v. Johnston*, 268 U.S. 220, 227 (1925). The particulars of the face-to-face negotiations and four-month investigation which preceded the sale do not present any issues "of importance to the public as distinguished from . . . the parties. . . ." *Layne & Bowler Corp. v. Western Well Works, Inc.*, 261 U.S. 387, 393 (1923).

In asking this Court to grant certiorari, petitioner has misstated the rulings of the Court of Appeals. The Second Circuit did not hold that reserve estimates are exempt from the disclosure requirements of the securities laws, it ruled as a matter of contract law that Quantum did not make any representations in the Stock Purchase Agreement concerning the adequacy of the reserves, except for the carefully-worded and limited guarantee in § 12. Nor did the Court rule that materiality standards are inapplicable to investors who retain professional

advisors, it held that information disclosed to the experts *in this transaction* made the Tillinghast reports immaterial as a matter of law. Finally, the Court did not overstep the bounds of FED.R.CIV.P.52: It set aside a finding under the clearly erroneous rule, applied accounting standards recognized by the District Court in its summary judgment decision, and ruled as a matter of law that the Tillinghast reports were immaterial.

1. THE COURT OF APPEALS DECIDED THE RESERVE ISSUES UNDER THE CONTRACT, NOT THE FEDERAL SECURITIES LAWS.

The Court of Appeals never held that reserve estimates "cannot be the basis of claims under § 12(2) or § 10(b)" or that "only misrepresentations of 'hard' facts are actionable under the securities laws. . . ." (Pet. at 15). It simply held as a matter of contract law that Quantum did not make *any* representations concerning the adequacy of the reserves in the Stock Purchase Agreement, other than the limited guarantee in § 12, and that the representations it did make concerning compliance with GAAP and accounting regularity in § 5 were truthful. The Court of Appeals, therefore, resolved the primary issue presented for review under state contract law, not the federal securities laws. In this regard, the approach (if not the judgment) of the Second Circuit was identical to that of the District Court.[10]

While the construction of a privately-negotiated agreement does not merit the attention of this Court, the interpretation adopted by the Court of Appeals was correct under New York law.[11] The absence of a specific warranty on the reserves in

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[10] The District Court restricted its rulings under the federal securities laws to the alleged concealment of the Tillinghast reports. *See* P.App.67a-70a.

[11] Since the District Court held that the contract was unambiguous (R.App. 8-9), the Court of Appeals was entitled to review its construction *de novo*. *Levy v. Gadsby*, 7 U.S. 180, 185, 3 Cranch 109, 112 (1805); *Hunt Ltd. v. Lifschultz Fast Freight, Inc.*, 889 F.2d 1274, 1277 (2d Cir. 1989).

the contract combined with unequivocal warranties on other balance sheet items, such as the adequacy of the tax reserves and the value of the bond portfolio, strongly indicated that § 5 was nothing more than "a warranty as to accounting accuracy and regularity, not a blanket guarantee of net worth" (P.App.48a). The construction adopted by the Second Circuit was buttressed by "a binding, post-purchase opportunity to arbitrate . . . the adequacy of Elkhorn's loss reserves" under § 12 of the contract (*id.*), which the trial court had earlier ruled was the exclusive remedy for resolving net worth disputes (R.App. 8-10).

Having decided that the representations in the contract were limited to accounting regularity and compliance with GAAP, the Second Circuit concluded that they were truthful as a matter of law. Peat Marwick certified that the June 30, 1983 balance sheet was prepared in accordance with GAAP and the Conning and Peat Marwick actuaries certified that the reserves were reasonable. Certifications by experts who knew *exactly* how the reserves were established was conclusive proof that the methodology and assumptions were reasonable and complied with GAAP (P.App.50a-51a).[12] Petitioner used the same reserve methodology when it prepared the September 30, 1983 balance sheet after the closing, which Peat Marwick also concluded was in accord with GAAP (P.App.25a). On appeal, petitioner did "not even argue that the actuarial method employed by Elkhorn . . . was inherently unreasonable or inconsistent with GAAP" (P.App.50a), nor did it present any evidence that the 65% ratio "was at the time viewed by professionals as so overly optimistic as to violate GAAP" (P.App.51a).

The fact that a third group of experts with the "glow of hindsight" produced a more "compelling" reserve estimate at trial showing a substantial deficiency was irrelevant in determining whether the Elkhorn reserving procedures were reasonable in

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[12] See *infra* at 14-15.

1983.[13] Petitioner never explained what this *third* battery of experts did after the fact that Conning and Peat Marwick could not have done before the sale (P.App.45a-46a). As a result, the Court of Appeals refused to construe the contract "to allow recovery of the full purchase price based on professional expert testimony in court that disagrees with the contemporaneous professional opinions expressed by Conning and Peat Marwick, firms hired by [petitioner] itself to render such opinions." *Id.*

Since the warranties in the contract were truthful, it follows *a fortiori* that they could not support a claim under the federal securities laws.[14] Even if the Court of Appeals had considered the reserve estimates under the securities laws, the result would have been the same. While reserve estimates are actionable if they lack a reasonable basis in fact, where the data, methodology, and assumptions underlying an estimate are disclosed

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[13] Although the Court of Appeals accepted the District Court finding that a substantial deficiency in the reserves "could have been detected from information available" in 1983 (P.App.44a), it also emphasized that this belated discovery was made "in the glow of hindsight" (P.App.22a-23a & n.2) and had "no relevance to the question of whether the June 30 balance sheet conformed with GAAP" (P.App.50a). With its team of actuaries and accountants, petitioner was in a better position than Quantum to understand the effect of account-date triangles on reserve estimates and therefore could not claim it was deceived. See *Vulcan Metals Co. v. Simmons Mfg. Co.*, 248 F. 853, 856-57 (2d Cir.), *cert. denied*, 247 U.S. 507 (1918) (L. Hand, J.); *Teamsters Local 282 Pension Trust Fund v. Angelos*, 762 F.2d 522, 530 (7th Cir. 1985); *Myzel v. Fields*, 386 F.2d 718, 736 (8th Cir. 1967), *cert. denied*, 390 U.S. 951 (1968); *McNabb v. Thomas*, 190 F.2d 608, 610-611 (D.C. Cir. 1951), *cert. denied*, 342 U.S. 859 (1951). Cf. *Shappirio v. Goldberg*, 192 U.S.. 232, 241-42 (1904).

[14] While the Court of Appeals did not reach the reserve claim under the federal securities laws, it did consider whether there were any violations of federal law for knowingly or recklessly misrepresenting the effect of the Elkhorn triangles, concluding, as did the trial court *sub silentio*, that no deception or recklessness was established. P.App.39a-43a. This was far from a "dead issue", as petitioner asserts (Pet. at 9 n.7), since it was the only reason why the reserve claim under the federal securities laws was not dismissed on summary judgment. See R.App. 13-14.

to a knowledgeable buyer, as they were here, the requirements of the federal securities law are fully satisfied.[15]

2. THE COURT OF APPEALS NEVER HELD THAT THE MATERIALITY STANDARD WAS INAPPLICABLE TO INVESTORS WHO RETAIN ADVISORS.

In asserting that the Court of Appeals "carved out an exception to the well-established objective standard of materiality" (Pet. at 18) and departed from the "total mix" test of *TSC Industries, Inc. v. Northway, Inc.*, 426 U.S. 438 (1976), petitioner has again misstated the ruling below. The Court of Appeals *expressly* applied the *TSC Industries* standard and concluded that the Tillinghast reports would not have affected the "total mix" of information disclosed to petitioner (P.App.34a-39a). The alleged "exception" to the objective standard was nothing more than the application of the total mix test to the circumstances of this case.

In assessing the significance of the Tillinghast reports to Delta Holdings, the Second Circuit necessarily restricted its analysis to the actuaries who were responsible for evaluating the reserves, as did petitioner and its expert witnesses in arguing the reports were material (P.App.37a). It would have been difficult to consider the reports in any other context since the business of Delta Holdings was run *entirely* by professionals in 1983. The Court of Appeals, however, did not vary the standard of materiality

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[15] The law "requires nothing more than the disclosure of basic facts so that outsiders may draw upon their own evaluative expertise in reaching" their decisions. *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 849 (2d Cir. 1968), *cert. denied*, 394 U.S. 976 (1969). *See Wielgos v. Commonwealth Edison Co.*, 892 F.2d 509, 512-16 (7th Cir. 1989); *Dower v. Mosser Indus., Inc.*, 648 F.2d 183, 188 (3rd Cir. 1981); *In re RAC Mortgage Inv. Corp.*, 765 F.Supp. 860, 864-65 (D.Md. 1991); *Pittsburgh Coke & Chemical Co. v. Bollo*, 421 F. Supp. 908, 924 (E.D.N.Y. 1976), *aff'd*, 560 F.2d 1089 (2d Cir. 1977). The significance of the information provided petitioner is apparent from the SEC rules on forward-looking statements, 17 C.F.R. § 240.175, which encourage but do not require disclosure of assumptions. According to the SEC, "disclosure of assumptions is perhaps the most significant factor in facilitating investor understanding" of estimates and projections. See Securities Act Release No. 5992, Fed.Sec.L.Rep. (CCH) ¶ 81,756 at 81,038 (Nov. 7, 1978).

because advisors were used, it applied the objective standard and concluded that *in this transaction* the reports "would have added nothing material" to what was already disclosed to Peat Marwick (P.App.40a). In a different transaction, the Court noted, the reports might have been significant to another actuary who did not have the benefit of the information available to Peat Marwick (P.App.37a).

The approach of the Court of Appeals was consistent with the requirement that materiality be "determined on a case-by-case basis", *Basic Inc. v. Levinson*, 485 U.S. 224, 250 (1988), taking into account "all the circumstances" of a particular transaction. *TSC Industries, Inc. v. Northway, Inc.*, 426 U.S. at 449. Implicit in the "total mix" test is the recognition that materiality will vary from case to case and that a document which might be significant in one case, may be immaterial in another. *Titan Group, Inc. v. Faggen*, 513 F.2d 234, 239 (2d Cir.), *cert. denied*, 423 U.S. 840 (1975).[16]

3. THE COURT OF APPEALS DID NOT USURP THE FUNCTION OF THE DISTRICT COURT.

The claim that the Court of Appeals overstepped the bounds of FED.R.CIV.P.52(a) is without foundation. The judgment of the District Court was reversed as a matter of law on all major issues. In fact, were it not for the allegations of deception relating to the account-date triangles, the entire complaint should have been dismissed on summary judgment based on undisputed evidence provided by Peat Marwick, Conning, and ARM during pretrial discovery.[17]

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[16] See *Kademian v. Ladish Co.*, 792 F.2d 614, 623 (7th Cir. 1986); *Michaels v. Michaels*, 767 F.2d 1185, 1197 (7th Cir. 1985), *cert. denied*, 474 U.S. 1057 (1986).

[17] The breach of warranty claim should have dismissed after the District Court ruled that § 12 was the exclusive remedy for resolving net worth disputes. The securities law claim for misrepresenting the reserves would have been dismissed on summary judgment were it not for the account-date triangle allegations. See R.App. 13-14. The summary judgment record showed, among other things, that Peat Marwick and Conning knew exactly how the reserves were

(Footnote continued)

In any event, each of the assigned errors was a proper exercise of appellate power. Initially, the Court of Appeals did not exceed its authority by setting aside the finding that Norton knew Elkhorn was insolvent before the sale. An appellate court is empowered to set aside a finding "when although there is evidence to support it, the reviewing court on the entire evidence is left with the definite and firm conviction that a mistake has been committed." *United States v. United States Gypsum Co.*, 333 U.S. 364, 395 (1948). After a meticulous review of the record, and without overturning the credibility findings of the trial court,[18] the Court of Appeals concluded there was no evidentiary basis for the finding that Norton "knew" the reserve estimates were understated to the point of insolvency in 1983 (P.App.31a-33a).

While petitioner may disagree with the clearly erroneous ruling, it cannot claim that the approach was in error or that the Court exceeded its authority. The unusually thorough opinion

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established before the sale, that Peat Marwick certified the June 30, 1983 balance sheet, that Conning and Peat Marwick conducted two independent examinations of the reserves for petitioner, that ARM and Peat Marwick prepared the September 30, 1983 balance sheet after the closing, and that the substance of the Tillinghast reports was disclosed to Peat Marwick, ARM, and Conning. Based on this nucleus of undisputed facts, the Court of Appeals reversed the District Court judgment as a matter of law.

[18] Although the Court of Appeals accepted the credibility findings that Norton prepared an initial calculation showing a $10 million deficiency as of December 31, 1980 (P.App.15a) and failed to disclose the Tillinghast reports to petitioner (P.App.33a), neither finding supported the conclusion that Norton "knew" the reserves were understated in 1983. The Court of Appeals properly concluded there was no support in the record for the finding that dated knowledge of the alleged insolvency to October 1981 when Tillinghast was engaged (P.App.31a). Nor was there any evidence in the record that Norton even "suspected Elkhorn's insolvency" after he prepared a reserve analysis showing a negligible deficiency at the end of 1982 (P.App.32a-33a). Norton gave copies of his 1982 analysis to Peat Marwick and Conning, who reviewed his assumptions and methodology and, after performing their own studies, concluded the estimates were reasonable. If Norton "knew" the reserves were deficient, so did Peat Marwick and Conning.

by a distinguished panel of judges demonstrates that the proper standard of review was applied and the "Court of Appeals . . . made a fair assessment of the record." *Peurifoy v. Commissioner*, 358 U.S. 59, 61 (1958). Because another reviewing panel might "find the record tilting one way rather than the other, though fair-minded judges could find it tilting either way", *NLRB v. Pittsburgh Steamship Co.*, 340 U.S. 498, 503 (1951), is not a special or important reason for granting certiorari. See *Dick v. New York Life Ins. Co.*, 359 U.S 437, 461-63 (1959) (Frankfurter, J., dissenting).

The claim that the Second Circuit exceeded its appellate authority by deciding "factual issues" concerning the requirements of GAAP is also misplaced. The relevant accounting standards for establishing reserves were never in dispute and were set forth in the summary judgment decision of the District Court.[19] Moreover, the critical issue was not what GAAP required, but what the contract required. Did Quantum warrant that the reserves were "accurate", as petitioner and the District Court believed, or did it warrant that the balance sheet complied with GAAP and, implicitly, that Elkhorn selected from "a range of 'reasonable' treatments" in establishing reserves? *Thor Power Tool Co. v. Commissioner*, 439 U.S. 522, 544 (1979).[20] The Court of Appeals construed § 5 as a warranty concerning reserve methodology, not a guarantee of reserve accuracy, and properly concluded that it was truthful as a matter of law (see *supra*

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[19] Citing the Audit Guide, the District Court found in its summary judgment opinion that the fairness of a reinsurance balance sheet under GAAP "rests on the reasonableness of the estimates of unpaid losses" (R.App. 13). The court also found that "[l]oss reserves are contingent on future events, and are very difficult to estimate" (*id.*). See Notes 4, 5, & 6, *supra* at 6-7.

[20] GAAP recognizes that in many areas there is no such thing as a "correct" answer, only "a range of 'reasonable' treatments" where "the choice among alternatives" is left to the discretion of management. *Thor Power Tool Co. v. Commissioner*, 439 U.S. 522, 544 (1979). "*Thor* requires the district court to defer to the professional judgment of the accountant who prepared" the balance sheet and "also limits a district court . . . to deciding only whether the accountant chose a procedure from the universe of generally accepted accounting principles." *Godchaux v. Conveying Techniques, Inc.*, 846 F.2d 306, 315 (5th Cir. 1988).

at 13-14). In any event, petitioner does not challenge the validity of the accounting principles recognized by the Court of Appeals, only its failure to cite specific authorities (Pet. at 23).

Finally, the claim that the Court of Appeals engaged in impermissible fact-finding when it determined that the Tillinghast reports were immaterial does not withstand scrutiny. A document is immaterial as a matter of law if its contents are in the public domain, *Johnson v. Wiggs*, 443 F.2d 803, 806 (5th Cir. 1971),[21] or its substance has been otherwise disclosed to the purchaser. *Kas v. Financial General Bankshares, Inc.*, 796 F.2d 508, 517 (D.C. Cir. 1986).[22] The information relating to reserve methodologies in the February 1982 report was in the public domain and was well known to Peat Marwick and Conning. The December 31, 1980 data in the appendix was provided petitioner in updated form in the June 30, 1983 triangles and, to the extent the format of the 1980 data would have revealed the account-date nature of the 1983 triangles, this matter was independently disclosed to Peat Marwick, as were the problems relating to the Barrett treaties in the April 1982 report (P.App.35a-39a).

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[21] See, e.g., *Ward v. Freeman*, 854 F.2d 780, 792-93 (5th Cir. 1988), *cert. denied*, 490 U.S. 1065 (1989); *Elkind v. Liggett & Myers, Inc.* 635 F.2d 156, 166 (2d Cir. 1980); *Hafner v. Forest Lab's, Inc.*, 345 F.2d 167, 168 (2d Cir. 1965).

[22] See, e.g., *Mayer v. Oil Field Systems Corp.*, 803 F.2d 749, 755 (2d Cir. 1986); *Frigitemp Corp. v. Financial Dynamics Fund, Inc.*, 524 F.2d 275, 282 (2d Cir. 1975); *Teamsters Local 282 Pension Trust Fund v. Angelos*, 762 F.2d 522, 530 (7th Cir. 1985); *Koplin v. Labe Federal Sav's & Loan Ass'n*, 748 F.Supp. 1336, 1342 (N.D. Ill. 1990); *Wollins v. Antman*, 638 F.Supp. 989, 994-95 (E.D.N.Y. 1986).

CONCLUSION

For these reasons, the Petition For Writ Of Certiorari should be denied.

Dated: Anaheim, California
March 25, 1992

Respectfully submitted,

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APPENDIX

UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF NEW YORK

DELTA HOLDINGS, INC.,	
Plaintiff,	
— against —	
NATIONAL DISTILLERS AND CHEMICAL CORPORATION,	85 Civ. 3439 (JFK)
Defendant and Third-Party Plaintiff,	
— against —	*OPINION and ORDER*
PEAT, MARWICK, MITCHELL & CO., AMERICAN RISK MANAGEMENT, INC., and FREDERIC M. REISS,	
Third-Party Defendants.	

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—and—

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JOHN F. KEENAN, United States District Judge

JOHN F. KEENAN, United States District Judge:

Background

Plaintiff, Delta Holdings, Inc., ("Delta Holdings") brought this lawsuit against defendant and third-party plaintiff National Distillers and Chemical Corp., ("National Distillers") for events arising out of a commercial transaction. In turn, National Distillers impleaded Peat, Marwick, Mitchell & Co. ("PMM")[1], American Risk Management, Inc. ("ARM") and Frederic M. Reiss seeking indemnification and contribution for any liability resulting from Delta Holdings' complaint.

In an Opinion and Order dated September 4, 1986, this Court dismissed National Distillers' claims for indemnification, and also dismissed National Distillers' claims for contribution with respect to the federal causes of action. At that time, the Court declined to dismiss the contribution claims on the state law claims. After that Opinion and Order was issued, the parties conducted and completed discovery.

Currently before the Court are various summary judgment and dismissal motions made by National Distillers, Reiss and PMM. National Distillers moves to dismiss the negligent misrepresentation and federal racketeering counts of the complaint. In addition, National Distillers seeks summary judgment on the claims that the contract between it and Delta Holdings was breached, as well as on the claims alleging common law fraud and violations of the federal securities laws. Reiss seeks summary judgment on the remaining claim National Distillers asserts against him, and PMM moves again to dismiss, in part, the claim asserted by National Distillers.

For the reasons set forth below, the Court grants in part, and denies in part, National Distillers' summary judgment motion. In addition, Reiss' motion for summary judgment is granted in full, and PMM's motion to partially dismiss is granted in full.

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[1] Peat, Marwick, Mitchell & Co. is now known as Peat Marwick Main & Co.

Facts

In 1981, an entity known as the Reiss Organization began to consider forming a new venture in the reinsurance industry. Simply put, reinsurance involves an insurer assuming a portion of the risks for which another insurer is liable. A reinsurer may insure either primary insurers or other reinsurers in return for a share of the premium. A company obtaining reinsurance, and relinquishing some of its risk, is known as a ceding company. These arrangements are established through what are called reinsurance treaties, which frequently involve the participation of numerous reinsurers. The new venture, which became known as Delta Holdings, would enter the reinsurance industry by either obtaining licenses in various jurisdictions, or by acquiring other, already licensed, reinsurance companies.

One such company was the Elkhorn Reinsurance Company ("Elkhorn"), a wholly owned subsidiary of National Distillers. Elkhorn was formed in 1965 to insure and reinsure the property and casualty risks of National Distillers. National Distillers retained ARM, a corporation formed by Reiss in 1962, to manage Elkhorn's business. In 1971, Elkhorn began assuming reinsurance risks other than those of its parent corporation. At the end of 1982, National Distillers decided to get out of the insurance industry, and focus on its other businesses. In April, 1983, discussions began between ARM and National Distillers concerning the possible sale of Elkhorn to Delta Holdings. After months of negotiation, and investigation by outside experts, a Stock Purchase Agreement ("SPA") was entered on September 30, 1983, pursuant to which Delta Holdings paid $18 million to National Distillers for Elkhorn. This agreement was based on a balance sheet showing Elkhorn had a net worth of $18 million.

After the transaction it became evident that Elkhorn, which had been renamed Delta Reinsurance, was not a financially healthy enterprise. While the trial of this action will resolve the numerous factual questions present, it is nonetheless useful at this time to outline what was seemingly wrong with Elkhorn.

In the reinsurance business, income is realized from two primary sources – premiums and investments. On the other side of the ledger, liabilities are somewhat uncertain and are categorized as loss reserves. As will be described below, loss reserves are a most critical calculation in determining the value of a reinsurance business. In essence, loss reserves are an estimate of the final settlement cost of all unpaid liabilities associated with insurance premiums that have been earned. Loss revenues are broken into two categories: case reserves, which are estimates of the cost of settling reported claims and IBNR (incurred but not reported) reserves, which are estimates of the cost of settling unknown or unreported claims. What makes loss reserves so critical, and hazardous, is the fact that the figure is merely an estimate.

In arriving at a loss reserve figure, at least two methods are used. The first, and more conservative, method is the book date basis which reflects the date a loss or premium was received and entered on the books of the reinsurer. The second approach is the account date basis. This latter method was used by Elkhorn, and reflects the date a loss or premium was reported to the ceding company and not to the reinsurer. Apparently, this method can cause a loss reserve estimate to be too low, which can result in financial instability for a reinsurer.

Reduced to its essentials, this case concerns Delta Holdings' charge that National Distillers knowingly sold it a reinsurance subsidiary that was worthless due to inaccurate loss reserve calculations. National Distillers basically responds that Delta Holdings and its agents, which included PMM and Conning & Co., had access to all the available information, and hence knew, or should have known, of Elkhorn's potential difficulties.

The true financial plight of Delta Reinsurance, formerly Elkhorn, began to emerge during 1984. In July, 1984, the Kentucky Insurance Department conducted an audit of Delta Reinsurance that revealed a $38 million deficiency in the loss reserves as of December 31, 1983. The Kentucky Insurance Department further employed an actuary to analyze Delta Reinsurance. This

study estimated the loss reserve deficiency as of December 31, 1983, to be between $34.5 million and $44.4 million. The actuary provided a final report to the Kentucky Insurance Department in March, 1985 which indicated that the loss reserve deficiency as of December 31, 1984 was between $67.8 million and $77.6 million. Not surprisingly, Delta Reinsurance was placed in rehabilitation on May 29, 1985 and in liquidation on approximately September 1, 1985.

It is Delta Holdings' view that National Distillers concealed Elkhorn's problems through, *inter alia*, the work of Robert Norton, Elkhorn's president, and a National Distillers director. This position is based in part on the fact that in 1982, Norton[2] retained the actuarial firm of Tillinghast, Nelson & Warren to examine Elkhorn's method of computing loss reserves, and to determine whether the loss reserves Elkhorn was carrying were adequate. The Tillinghast report of February, 1982 found Elkhorn's loss ratio too low and a loss reserve deficiency of $11 million as of December 31, 1980. A second report, issued in April, 1982, found that as of December 31, 1981, Elkhorn's loss reserve was deficient by $20 million. It is asserted that these facts, as well as Norton's own calculations, were concealed from Delta Holdings during the negotiations. The complaint sets forth other alleged misrepresentations and omissions that will also be considered at trial.

National Distillers takes the position that Delta Holdings ignored its own experts. It is advanced that despite the fact that Delta Holdings went through with the transaction two PMM actuaries found that Elkhorn had a total reserve deficiency of $8.5 million. Moreover, a PMM auditor discovered that the loss reserves Elkhorn calculated used the account date basis, instead of the more frequently employed book date basis.

This outline of the facts is hardly exhaustive, and the instant motions clearly do not dispose of the case. However, these

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[2] After the SPA was executed, Norton remained on as president of Elkhorn/Delta Reinsurance. He resigned on September 14, 1984, after the initial findings of the Kentucky Insurance Department.

motions, which have been well briefed by the parties, and this decision will hopefully serve to narrow somewhat the issues to be tried.

DISCUSSION

I. Delta Holdings' Claims Against National Distillers

A. The Alleged Breach of § 12 of the Stock Purchase Agreement.

National Distillers seeks summary judgment on Delta Holdings' contention that § 12 of the SPA was breached because Elkhorn's net worth was less than $18,000,000 as of September 30, 1983. Section 12 provides as follows:

> 12. *Adjustment To Purchase Price.* No later than October 17, 1983, Buyer shall deliver a balance sheet of Elkhorn as at September 30, 1983 (the "September 30th Balance Sheet"), prepared in accordance with GAAP and on the same basis as used in the preparation of the June 30th Balance Sheet. The book value of all Bonds, Preferred and Common Stocks included in the September 30, 1983 Balance Sheet will be determined by Princeton Financial Systems Inc. and shall be binding on all parties. Seller guarantees to Buyer that the Net Worth of Elkhorn, as at September 30, 1983 shall not be less than $18,000,000.
>
> In the event that the Net Worth of Elkhorn is greater than $18,000,000 as shown on the September 30th Balance Sheet, then Elkhorn shall pay a dividend to the Seller on or before the 28th October 1983 in an amount sufficient to reduce the Net Worth of Elkhorn to $18,000,000 in accordance with Clause 10 hereof.
>
> In the event that the Net Worth of Elkhorn as shown on the September 30th Balance Sheet is less than $18,000,000, then Seller shall pay such deficit to the Buyer at Fort Lee, New Jersey, or before the 31st of October, 1983, or if such Balance Sheet shall be

> disputed (as below provided) then payment shall be made promptly after the settlement of such dispute.
>
> In the event Seller disputes the September 30th Balance Sheet, Seller shall advise the Buyer not later than the 25th October, 1983 and any such dispute, if not resolved promptly between the parties, shall be resolved by the opinion of Peat, Marwick, Mitchell & Co., which said opinion shall be final and conclusive and binding on all parties hereto.

Delta Holdings posits that the guaranty of Elkhorn's value, set forth in the last sentence of the first paragraph, stands apart from the rest of § 12. According to Delta Holdings, that sentence, when read in conjunction with § 15,[3] supports a cause of action in the event Elkhorn's net worth was less than $18,000,000 on September 30, 1983. Delta Holdings argues that such a surviving guaranty was important to it when negotiating the purchase. Moreover, it is asserted that the clause only makes sense when read as a full fledged guaranty that Delta Holdings would receive $18,000,000 in value in exchange for its $18,000,000 payment to National Distillers. Delta Holdings urges that summary judgment is inappropriate on this claim since there are two reasonable interpretations of § 12.

On the other hand, National Distillers' motion for summary judgment argues that § 12 is clear, unambiguous and susceptible to only one reasonable interpretation. According to National Distillers, the rights granted to the parties under § 12 expired on October 31, 1983. In addition, the parties' exclusive remedy for resolving disputes concerning Elkhorn's September 30, 1983 net worth was submission to PMM for a "final and conclusive and binding" resolution. In the Court's view, these points are clearly and unambiguously articulated in § 12, and summary judgment in favor of National Distillers is required on this claim.

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[3] Section 15 of the SPA provides, "[e]ach of the representations, warranties, covenants and other agreements made in this Agreement shall survive the execution and delivery of this Agreement, the delivery and transfer of the shares and the payment of the Purchase Price, and shall continue in full force and effect."

The standard for granting summary judgment is clear. Where no genuine issue of material fact exists, and the applicable law is in the movant's favor, then summary judgment in favor of the movant is mandated. In contract actions, summary judgment is an appropriate manner of disposition when the contract's terms are clear and not conducive to more than one reasonable interpretation. *Tokio Marine and Fire Ins. Co. v. McDonnell Douglas Corp.*, 617 F.2d 936, 940 (2d Cir. 1980). A threshold question of law for the Court is whether the terms of the agreement are clear and unambiguous. *Walk-In Medical Centers, Inc. v. Breuer Capital Corp.*, 818 F.2d 260, 263 (2d Cir. 1987).

As noted above, the Court finds § 12 to be clear and unambiguous. Although National Distillers guaranteed the net worth of Elkhorn in § 12, this particular guarantee is intertwined with procedures and remedies lucidly set forth within that section. If Elkhorn's net worth were determined to be more than $18,000,000, then Delta Holdings was to pay National Distillers the difference between the net worth and $18,000,000 on or before October 28, 1983. If Elkhorn's net worth were determined to be less than $18,000,000, then National Distillers was to pay Delta Holdings that difference by October 31, 1983. Disputes were to be resolved either by the parties themselves, or by PMM. It is significant to note that the guaranty of Elkhorn's worth was set forth in the section entitled "Adjustment to Purchase Price," and not in § 5 of the SPA which contained general warranties and representations. Moreover, § 12 makes no reference to § 15 which provides for the continuing effect of "representations, warranties, covenants and other agreements." The parties clearly understood the need for cross-references to other sections within the SPA as shown by the reference in § 12 to § 10. Section 12 makes no reference to either § 5 or § 15.

Section 12 is a specific provision. New York law, which applies in this case pursuant to a clause in the SPA, is clear regarding the relationship between general and specific provisions within a contract. "A specific provision will not be set aside in

favor of a catchall clause." *Williams Higgins & Sons, Inc. v. State*, 20 N.Y. 2d 425, 428, 284 N.Y.S. 2d 697, 699, 231 N.E.2d 285 (1967); *see also John Hancock Mutual Life Ins. Co. v. Carolina Power & Light Co.*, 717 F.2d 664, 669 n.8 (2d Cir. 1983) ("New York law recognizes that definitive, particularized contract language takes precedence over expressions of intent that are general, summary, or preliminary.").

This Court is powerless to hear parole evidence as to Delta Holdings' intent and understanding of the provision because the agreement is clear, complete and valid. *See New York State Energy Research & Development Authority v. Nuclear Fuel Services, Inc.*, 640 F. Supp. 1555, 1557 (W.D.N.Y. 1986); *United States v. Wallace & Wallace Fuel Oil Co.*, 540 F. Supp. 419, 425 (S.D.N.Y. 1982). This Court is also powerless to "rewrite a contract to accord with its instinct for the disposition of equity under the facts of a case." *Broad v. Rockwell Int'l Corp.*, 642 F.2d 929, 947 (5th Cir.), *cert. denied*, 454 U.S. 965 (1981). The Court will not transform the clear, specific and narrow guaranty of § 12 into a general warranty that should have been, for Delta Holdings' purposes, set forth in § 5.

Summary judgment is entered in National Distillers' favor concerning claims that § 12 of the SPA was breached.

B. The Alleged Breach of Representations and Warranties Contained in § 5 of the Stock Purchase Agreement.

Section 5(g) of the SPA contains a warranty by National Distillers that,

> [t]he June 30th [1983] Balance Sheet and related statement of income are complete and accurate in all material respects, were prepared in accordance with Generally Accepted Accounting Principles ("GAAP"), and the June 30th Balance Sheet presents fairly the financial position of Elkhorn as at that date.

The complaint alleges that this warranty was breached. The June 30, 1983 balance sheet indicated that Elkhorn had an

$18,000,000 net worth and loss reserves of $45,017,000. According to Delta Holdings, however, the balance sheet understated the loss reserve liability by at least $34,000,000, and as a result, Elkhorn had a negative net worth of at least $16,000,000.

The SPA further provided, at section 5(f), a warranty from National Distillers that,

> [t]he books and records of Elkhorn are complete in all material respects and have been maintained in accordance with good business and accepted insurance practices and principles and accurately reflect the financial condition and results of the operation of Elkhorn.

The complaint asserts that this warranty was breached in that the June 30, 1983, and September 30, 1983 balance sheets did not accurately reflect Elkhorn's condition. Furthermore, Delta Holdings contends that Elkhorn's records were not kept in accorance with good business and accepted insurance practices. As mentioned earlier in this Opinion, the essence of this claim is that Elkhorn should have employed a book date basis, rather than an account date basis, in calculating loss reserves.

National Distillers moves for summary judgment on these breach of warranty claims, asserting that Delta Holdings did not rely on these warranties in making the contract. Furthermore, National Distillers states that Delta Holdings knew that the warranties and representations were inaccurate when made.

The Court denies summary judgment on these claims. The parties vigorously dispute whether reliance is an element in a breach of warranty claim. The Court concludes that reliance is not an element in that cause of action, and follows *CPC International, Inc. v. McKesson Corp.*, 134 Misc. 2d 834, 513 N.Y.S. 2d 319 (N.Y. Sup. Ct. 1987), and *Ainger v. Michigan General Corp.*, 476 F. Supp. 1209 (S.D.N.Y. 1979), *aff'd*, 632 F.2d 1025 (2d Cir. 1980). As Judge Cannella stated in *Ainger*, "[w]here the warranty is proved — and especially where it is expressly stated in a signed writing — the promisor should be allowed

to disclaim 'the bargain of the parties in fact as found in their language' . . . only in an extraordinary case, such as one involving illegality or some other overriding consideration of public policy." *Ainger*, 476 F. Supp. at 1225.

This is a case where the warranties are clearly set forth in a signed writing. To require reliance as an element of a breach of warranty claim in such a case would create uncertainty in the commercial context, and blur the differences between warranty claims and misrepresentation claims. The Court also notes, for reasons set forth later, that questions of fact clearly exist concerning Delta Holdings' knowledge of the financial statements' accuracy, and the role National Distillers played in Delta Holdings' obtaining and understanding this knowledge.

C. The Allegations of Fraud.

Delta Holdings claims that National Distillers committed common law fraud and violated the federal securities laws. The federal claims are asserted under § 12(2) of the Securities Act, 15 U.S.C. § 771, and § 10(b) of the Securities Exchange Act, 15 U.S.C. § 78j, and Rule 10b-5 promulgated thereunder, 17 C.F.R. § 240.10b-5. National Distillers seeks summary judgment on these claims of fraud.

National Distillers argues that actual knowledge of inaccurate representations or warranties bars an action for fraud. *See Rosenbloom v. Adams, Scott & Conway, Inc.*, 521 F. Supp. 372, 390 (S.D.N.Y. 1981), *aff'd mem.*, 688 F.2d 816 (2d Cir. 1982); *Pittsburgh Coke & Chemical Co. v. Bollo*, 421 F. Supp. 908, 925 (E.D.N.Y. 1976), *aff'd*, 560 F.2d 1089 (2d Cir. 1977); *200 East End Avenue Corp. v. General Electric Co.*, 5 A.D.2d 415, 418, 172 N.Y.S.2d 409 (1st Dep't 1958), *aff'd*, 6 N.Y.2d 731, 185 N.Y.S.2d 816, 153 N.E.2d 508 (1959). National Distillers asserts that no genuine issue of material fact exists concerning Delta Holdings' knowledge of Elkhorn's true financial condition at the time of the SPA. The Court differs, and declines to grant summary judgment to National Distillers on the fraud claims.

According to National Distillers, Delta Holdings knew before September 30, 1983 that the Elkhorn loss development triangles used to calculate loss reserves were done on an account date basis. National Distillers reasons that this information was known to PMM and Conning, and since they served as agents for Delta Holdings, the information is to be imputed to the plaintiff. Furthermore, National Distillers notes that no fraud claim can arise out of any inaccuracy in the June 30, 1983 and September 30, 1983 financial statements because Delta Holdings had actual knowledge of the basis on which the loss reserve estimates were made.

Through its agents, Delta Holdings knew that loss reserve figures were estimates. Loss reserves are contingent on future events, and are very difficult to estimate. However, the importance of these loss reserves is profound. In fact, the American Institute of Certified Public Accountants ("AICPA") has stated that, "[t]he fairness of the [insurance] company's representation of its financial position and results of operations usually rests on the reasonableness of the estimates of unpaid losses more than on any other item." Tesoriero Affidavit, Exh. 2, AICPA Industry Audit Guide, Audits of Fire and Casualty Insurance Companies at 28. The critical nature of loss reserves was certainly known to National Distillers and Norton.

Although Delta Holdings knew that Elkhorn used an account date basis to formulate its loss reserves, Delta Holdings was unaware of certain facts that could have altered its view of Elkhorn as an acquisition. During PMM's evaluation of Elkhorn, the accounting firm sought Norton's assistance in certain areas. PMM observed that certain development point numbers on the Elkhorn loss development triangles were changing between the December 31, 1982 analysis, and the June 30, 1983 analysis. This concerned PMM officials who sought the assistance of Norton and Cascio. Elkhorn personnel, who presumably knew more about their company than anyone else, indicated that the main difference between use of the account date instead of the book date would be seen in the most recent underwriting year. *See* Tesoriero Affidavit, Exh. 39, Wasserman Deposition at 121-22; *Id.*, Exh. 29, Kaufman Deposition at 178-79. An issue of fact exists concerning the depth of Norton's knowledge on this subject.

See Tesoriero Affidavit, Exh. 40, Factor Deposition at 134. Norton's important role in PMM's examination is clear from another portion of the Wasserman deposition. PMM wanted to see whether Elkhorn's use of the account date basis only effected 1982 figures, as indicated by Elkhorn personnel. To do this, PMM asked Norton and Cascio to produce representative brokers' statements. A question of fact exists concerning whether Norton produced truly representative statements, or whether certain statements were chosen in an effort to mollify PMM's concerns. *See id.*, Exh. 39, Wasserman Deposition at 126-28.

Moreover, serious questions of material fact exist concerning the non-disclosure of the Tillinghast documents. As mentioned earlier, it is alleged that the actuarial firm of Tillinghast, Nelson & Warren was retained by Elkhorn in 1981 to examine Elkhorn's procedures and formulas. In February, 1982, Tillinghast completed its report which contained a different methodology for the calculation of loss reserves. When Norton applied this approach, he found that the loss reserves as of December 31, 1981 were understated by $6,300,000. Tillinghast issued another report in April, 1982 that evaluated the loss reserves for three reinsurance treaties. This report indicated ultimate losses on these three treaties would be $26,800,000. However, the loss reserves carried by Elkhorn for these treaties was only $18,700,000 as of December, 1981. These facts were withheld from PMM, and could have alerted the firm to the magnitude of Elkhorn's financial problems. *See* Appendix to Delta Holdings' Memorandum of Law, Exh. 23, Kaufman Deposition at 73-75. Thus, Norton, and others for whom National Distillers is responsible, may have withheld material information from Delta Holdings' agents in an effort to brighten Elkhorn's financial picture, and curtail Delta Holdings' understanding of the situation.

The legal significance of these issues is clear. The duty under the federal securities laws to disclose all material facts necessary to make other statements fair, "is not discharged merely by giving the purchaser access to company records and letting him piece together the material facts if he can." *Metro-Goldwyn-Mayer, Inc. v. Ross*, 509 F.2d 930, 933 (2d Cir. 1975). The securities

laws contemplate investors having "full access" to material information. *Hirsch v. du Pont*, 553 F.2d 750, 763 (2d Cir. 1977). In this case, factual questions concerning Delta Holdings' access to information and National Distillers' assistance to Delta Holdings in evaluating Elkhorn's financial condition remain unanswered.[4] For this reason, National Distillers' motion for summary judgment on the fraud claims is denied.

D. Alleged Violation of § 12(2) of the Securities Act of 1933.

Delta Holdings alleges that National Distillers violated § 12(2) of the Securities Act of 1933 by making material misrepresentations and omissions in connection with the Elkhorn sale. Specifically, it is claimed that National Distillers concealed the two reports prepared by Tillinghast in 1982, Norton's calculations based on those reports, and certain monthly management reports. National Distillers argues that this cause of action is barred by the one year statute of limitations applicable to section 12(2), *see* 15 U.S.C. § 77m, and that summary judgment is appropriate.

According to National Distillers, the lawsuit was commenced 20 months after the sale, and that during this period, Delta Holdings had constructive knowledge of the alleged misstatements and omissions. This constructive knowledge argument is based upon Delta Re's employment of three holdovers

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[4] The establishment, and judgment, of loss reserves can lead to liability under the federal securities laws whether one views loss reserve estimates as either facts or opinions. *See Lewis v. Black*, Fed. Sec. L. Rptr., ¶ 95,715 at 90,476 (E.D.N.Y., Sept. 3, 1976) (CCH); *Oleck v. Fischer*, 401 F. Supp. 651, 657 (S.D.N.Y. 1975); *cf. CPC International, Inc. v. McKesson Corp.*, 70 N.Y.2d 268, 519 N.Y.S.2d 804, 813, 514 N.E.2d 116 (1987) (projection of corporation's expected financial performance may constitute material facts to support a fraud claim). This is also true in the context of common law fraud and the insurance industry. *See Glacier General Assurance Co. v. Casualty Indemnity Exchange*, 435 F. Supp. 855, 860 (D. Mont. 1977) ("If the [loss reserve] figures so published are determined arbitrarily and with the intent to deceive and are in fact false, then the publisher is guilty of fraud regardless of whether his expression be one of fact or one of opinion.").

from Elkhorn: Robert Norton, Hugh C. Brewer, III and James D. McGurty. National Distillers contends that the knowledge of these individuals is to be imputed to Delta Holdings under established principles of agency.

Delta Holdings argues that Brewer and McGurty did not know about all of the alleged misrepresentations and omissions made by Norton. Moreover, it is contended that these two individuals lacked knowledge of all of the underlying facts. Regarding Norton, Delta Holdings seeks application of the adverse interest exception that would prevent it from being imputed with Norton's knowledge. Therefore, this reasoning continues, Delta Holdings cannot be deemed to have known of these misrepresentations and omissions until it obtained actual knowledge of them in September, 1984. Since the action was filed in May, 1985, the statute of limitations defense would fail.

The Court concludes that summary judgment is inappropriate on the statute of limitations defense. The extent of Brewer's and McGurty's knowledge of the concealments is unclear, and is much better resolved at trial. If it is established at trial that these individuals had full knowledge of the concealments, and were not part of the alleged fraud, then the statute of limitations could bar the section 12(2) claims. Under the adverse interest exception, Norton's knowledge can certainly not be imputed to Delta Holdings at this point in the case because Norton's failure to disclose his earlier concealments was possibly done in an effort to protect himself from a lawsuit such as this one.

The New York Court of Appeals has limited the circumstances in which the adverse interest exception may be used. It is only applicable when an agent has "totally abandoned his principal's interests and . . . [is] acting entirely for his own or another's purposes. It cannot be invoked merely because he has a conflict of interest or because he is not acting primarily for his principal." *Center v. Hampton Affiliates, Inc.*, 66 N.Y.2d 782, 785, 497 N.Y.S.2d 898, 900, 488 N.E.2d 828 (1985). At the present time, one can reasonably infer from the facts presented that as to the earlier misstatements and omissions, Norton "totally abandoned" the interests of Delta Re. Denial of summary judgment

on the statute of limitations issues is entirely consistent with "the ancient principle that no man can take advantage of his own wrong." *Katz v. Amos Treat & Co.*, 411 F.2d 1046, 1055 (1969) (citing *Glus v. Brooklyn Eastern District Terminal*, 359 U.S. 231, 232-34 (1959)).

E. Alleged Violations of RICO.

Delta Holdings' complaint alleges that National Distillers violated the Racketeer Influenced and Corrupt Organizations Act, 18 U.S.C. §§ 1961-1968 (1982 & Supp. III 1985) ("RICO"), and that Elkhorn constituted the enterprise. According to Delta Holdings, National Distillers violated section 1962(c), which requires "(1) conduct (2) of an enterprise (3) through a pattern (4) of racketeering activity." *Sedima, S.P.R.L. v. Imrex Co., Inc.*, 473 U.S. 479 (1985). National Distillers moves to have this cause of action dismissed.

In essence, Delta Holdings' contention is that in conjunction with the SPA, National Distillers concealed the understatement of Elkhorn's loss reserves and overstated Elkhorn's net worth. In so doing, National Distillers committed the predicate acts of mail fraud and wire fraud. Although more than one predicate act is alleged, this Court rules that the complaint does not state a cause of action under RICO. Delta Holdings does not plead, as is required by the Second Circuit, "the existence of an enterprise whose illicit activities or unlawful goals are continuing ones." *Creative Bath Products, Inc. v. Connecticut General Life Insurance Co.*, 837 F.2d 561, 564 (2d Cir. 1988) (citing *Albany Insurance Co. v. Esses*, 831 F.2d 41 (2d Cir. 1987); *Beck v. Manufacturers Hanover Trust Co.*, 820 F.2d 46 (2d Cir. 1987), *cert. denied*, 108 S. Ct. 698 (1988). This case involves allegations of fraud in the context of one stock purchase agreement. The illicit goal of the alleged enterprise was "straightforward" and "short-lived." *See Beck*, 820 F.2d at 51. It is claimed that National Distillers engaged in fraud when it sold Elkhorn to Delta Holdings. This does not present a situation posing the threat of continuing criminal conduct that RICO seeks to combat. *See United States v. Ianniello*, 808 F.2d 184, 192 (2d Cir. 1986), *cert. denied*, 107 S. Ct. 3229 (1987); *Chamarac v. Pike*, No. 86 Civ. 7919 slip op. at 19-20 (S.D.N.Y. Oct. 28, 1987) (JFK)

(complaint describing on-going, open-ended limited real estate partnership stated RICO claim). The RICO cause of action in Count V of Delta Holdings' complaint is dismissed.

F. The Alleged Negligent Misrepresentations.

Delta Holdings claims that National Distillers negligently misrepresented material facts, including Elkhorn's net worth as reflected on the June 30, 1983 net assets statement, and on the September 30, 1983 balance sheet. National Distillers moves to dismiss this claim, arguing that it fails to meet the required elements under New York law.

It is well-established in this state that in a negligent misrepresentation claim, a "special relationship" must exist between the parties. This rule was first set forth by the New York Court of Appeals in *International Products Corp. v. Erie R.R. Co.*, 244 N.Y. 331, 155 N.E. 662, *cert. denied*, 275 U.S. 527 (1927). There, the court stated that "the relationship of the parties, arising out of contract or otherwise, must be such that in morals and good conscience the one has the right to rely upon the other for information, and the other giving the information owes a duty to give it with care . . . An inquiry made of a stranger is one thing; of a person with whom the inquirer has entered or is about the enter into a contract concerning the goods which are or are to be its subject is another." 244 N.Y. at 338. Although there is some suggestion that parties who are negotiating do not have the requisite "special relationship," *see Accusystems, Inc. v. Honeywell Information Systems, Inc.*, 580 F. Supp. 474, 481 (S.D.N.Y. 1984); *Dynamics Corp. of America v. International Harvester Co.*, 429 F. Supp. 341, 356 (S.D.N.Y. 1977); the words of *International Products* indicates that such a black-letter rule is inappropriate. The "special relationship" concept must be adaptable to numerous contexts, and turns on the facts of each case. While the complaint describes a commercial relationship, the Court cannot conclude that the relationship could not have been "special." This determination must await the development of all of the facts at trial.

The motion to dismiss the negligent misrepresentation claim is denied.

II. National Contribution Claim Against Frederic M. Reiss

Reiss moves for summary judgment against National Distillers' third-party complaint seeking contribution on the state law claims. The Court has previously dismissed the third-party claims as to the federal causes of action in an Opinion dated September 4, 1986.

Although the broad facts were set forth earlier, some particular circumstances concerning Reiss should be noted here. Reiss had a long career in the reinsurance industry, stretching back to 1946. In the early 1960's, Reiss moved to Bermuda where he built a network of management companies that administered his various insurance and reinsurance operations. During the early 1980's, he was an active player in the formation of Delta Holdings, and had served as Chairman of the Board of Directors for a period of time. Reiss was also an active participant in Delta Holdings' consideration of possible acqusitions of reinsurance companies, including Elkhorn Reinsurance. In fact, on July 18, 1983, Reiss indicated to the Advisory Committee of Delta Holdings' Board that the Elkhorn acquisition initially looked positive, but much work would still have to be done. Reiss also recommended that outside professional firms be retained to verify independently the assets and reserves of any possible acquiree with an ongoing book of business. After Elkhorn emerged as a candidate, the Advisory Committee approved the engagement of Conning & Co. and PMM to review Elkhorn and its reserves. Conning & Co. opined that the loss reserves were adequate, and PMM certified the June 30, 1983 pro forma statement of Elkhorn's net assets.

An examination of the material facts and relevant law demonstrates that summary judgment must be entered in favor of Reiss. As an initial proposition, the Court again notes that contribution is available when "the third-party's conduct contributed to the 'same injury' suffered by the plaintiff." *Delta Holdings v. National Distillers and Chemical Corp.*, [1986-1987 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 92,910 at 94,427 (S.D.N.Y. September 4, 1986). Delta Holdings' harm in this action

is the purchase and possession of a valueless asset. *See id.* Any claim that Reiss should contribute to National Distillers – in the event National Distillers is found liable under state law – due to his failure to evaluate Elkhorn's future profitability is meritless. This case essentially concerns the sale of a company allegedly worthless at the time of the transaction, and not the extent of the company's future profitability.

Several additional grounds exist that compel summary judgment in Reiss' favor. National Distillers urges that Reiss is liable for contribution due to his failure to review personally Elkhorn's business. National Distillers further contends that Reiss failed to keep himself abreast of the investigation into Elkhorn performed by his staff, Conning & Co. and PMM. Moreover, National Distillers argues that Reiss had a duty to supervise actively the investigation because he was a Delta Holdings director, and was ARM's sole beneficial officer and chief executive officer. Lastly, National Distillers asserts that Reiss is liable for telling the Delta Holdings directors that the Elkhorn transaction looked positive at first review, and for relying on outside experts to evaluate Elkhorn. Each of these positions is unavailing.

First, the claims against Reiss as a director of Delta Holdings cannot be asserted by National Distillers. National Distillers was not a Delta Holdings shareholder at the time of the challenged conduct. Therefore, National Distillers lacks standing to assert this claim since allegations that a director breached his affirmative duties to a corporation may only be maintained by the corporation or its shareholders. *See Index Fund, Inc. v. Hagapian*, 417 F. Supp. 738, 745 (S.D.N.Y. 1976). The business judgment rule, recognized in both New York and Delaware, further bars the claim for contribution. Under this rule, a director will not be liable for actions taken in the honest belief that they were in the corporation's best interests, provided the actions were informed and made in good faith. *See Hanson Trust PLC v. ML SCM Acquisition, Inc.*, 781 F.2d 264, 273 (2d Cir. 1986); *Auerbach v. Bennett*, 47 N.Y.2d 619, 629, 419 N.Y.S.2d 920, 926, 393 N.E.2d 994 (1979); *Smith v. Van Gorkum*, 488 A.2d 858, 872 (Del. 1985). To hold Reiss liable as a director, there would have to be evidence that his conduct was fraudulent or in bad faith,

or constituted a gross abuse of discretion. Even when considered in the light most favorable to National Distillers, the facts adduced on this motion do not raise a question of material fact.

In hindsight, one could argue Reiss might have been wise to ask more questions or read more documents. However, hindsight is not the relevant analysis. One must evaluate Reiss' conduct as of the time it took place. Reiss did not blindly urge Delta Holdings to plunge into an $18 million purchase. Rather, he indicated that while the Elkhorn acquisition appeared promising, much investigating needed to be done. Outside experts were hired to evaluate Elkhorn, and their conclusions, albeit flawed, were relied on in good faith. The Court finds nothing to suggest the contrary. Reiss further relied in good faith on other favorable reports and representations, included among them representations from Norton. Reiss' conduct does not approach the required standard at which he would lose the protection of the business judgment rule.

Reiss cannot be found liable for contribution to National Distillers based on his alleged nonfeasance as an ARM officer. National Distillers contends that Reiss did not meet personally with the auditors and insure that all of the transaction's risks were resolved. These are charges of nonfeasance, and do not support a finding of an agent's liability to one other than his principal. *See Marine Midland Bank v. John E. Russo Produce Co.*, 50 N.Y.2d 31, 45, 427 N.Y.S.2d 961, 969, 405 N.E.2d 205 (1980); *Jones v. Archibald*, 45 A.D.2d 532, 534-35, 360 N.Y.S.2d 119, 122 (4th Dep't 1974).

Equally erroneous is National Distillers' argument that Reiss made negligent misrepresentations at the July 18, 1983 Advisory Committee meeting. At that time, Reiss apparently stated that, "Elkhorn Re looked very positive on first review, but still required a lot of work. On the positive side, National Distillers was willing to sell Elkhorn Re for (GAAP) book value." When made, this statement was not a misrepresentation. Reiss did not state that Elkhorn was a flawless acquisition and that the transaction should be completed immediately. Rather, he noted that more work needed to be done. This was accurate, as was Reiss' statement of the positive aspects of the transaction.

National Distillers argument that Reiss breached his duties as a promoter of Delta Holdings also misses the mark. By the time the transaction at issue occurred, Reiss' duties as a promoter had ceased. A Board of Directors was in place and was operating. Furthermore, there is no allegation that Reiss concealed any facts from the subscribers, even if National Distillers possessed standing to assert such a claim. Finally, the Court rejects National Distillers position that Reiss may be liable because he is the sole beneficial owner of ARM. Generally, stockholders are not liable for the obligations of a corporation unless the corporate entity is a sham and agent for a controlling shareholder. This has not been alleged in this case, and no evidence before the Court presents a genuine issue of material fact in this regard.

The summary judgment motion made by Reiss as to National Distillers' contribution claim is hereby granted.

III. The Motion of Peat, Marwick, Mitchell & Co. to Dismiss National Distillers' Contribution Claims

PMM renews its motion to dismiss National Distillers' contribution claim to the extent it is based on National Distillers' liability to Delta Holdings for breaches of the SPA. As set forth earlier, the Court grants summary judgment to National Distillers on that part of Count I of the complaint alleging § 12 of the SPA was breached. The Court, however, denies summary judgment on the allegations in Count I concerning breaches of §§ 5(g) and 5(f) of the SPA.

The Court need not dwell on PMM's instant motion because the central issue has been resolved by the New York State Court of Appeals. In *Board of Education v. Sargent, Webster, Crenshaw & Foley*, 71 N.Y.2d 21 (1987), *aff'g* 125 A.D.2d 27, 511 N.Y.S.2d 961 (3d Dep't 1987), the court ruled that New York's contribution statute, CPLR § 1401, does not apply in the breach of contract setting. The court traced the evolution of contribution in New York and noted that § 1401 "had its genesis in tort law and in the complications surrounding the apportionment of liability among joint tort-feasors." *Id.* N.Y.2d at 27. Thus, National Distillers may not seek contribution from PMM to the

extent National Distillers is found liable for breaching §§ 5(g) and 5(f) of the SPA.

PMM's partial motion to dismiss is granted.

CONCLUSION

National Distillers motion for summary judgment on that portion of Count I dealing with § 12 of the SPA is granted. In addition, the RICO cause of action is dismissed because no pattern of racketeering activity is present. All other portions of National Distillers' motion are denied. The motion of Reiss is granted in full, and PMM's motion for partial dismissal is granted.

The parties are to appear for a pretrial conference on April 20, 1988 at 9:45 a.m. At that time, a firm date for trial will be set.

SO ORDERED.

Dated: New York, New York
April 8, 1988

/s/ John F. Keenan

JOHN F. KEENAN
U.S.D.J.

Supreme Court, U.S.
FILED
APR 3 1992
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(3)

No. 91-1361

IN THE

Supreme Court of the United States

OCTOBER TERM, 1991

DELTA HOLDINGS, INC.,

Petitioner,

—against—

NATIONAL DISTILLERS AND CHEMICAL CORPORATION,

Respondent.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

REPLY BRIEF IN SUPPORT OF PETITION FOR WRIT OF CERTIORARI

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IN THE

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DELTA HOLDINGS, INC.,

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—against—

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PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

REPLY BRIEF IN SUPPORT OF PETITION FOR WRIT OF CERTIORARI

Preliminary Statement

Petitioner submits this brief in reply to respondent's Brief in Opposition to Writ of Certiorari ("Opp. Br."). Respondent's brief fails to confront the issues of broad public importance presented in the Petition for Writ of Certiorari (the "Petition"):

1. Respondent does not even attempt to rebut Delta's showing that effective enforcement of the nation's securities laws would be seriously impeded by the holding of the Second Circuit—contrary to the decisions of this Court and

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1 Petitioner has no parent corporation, subsidiaries or affiliates.

other circuits—that misstatements of reserve liabilities in financial statements are effectively immune from scrutiny under the federal securities laws. Rather, respondent argues that the decision below was based on state contract law. It is axiomatic, however, that federal, not state, law determines what is an actionable misrepresentation under the federal securities laws. And as we have demonstrated, the decision below conflicts with the *federal* securities laws as interpreted by this Court and other circuits, and would seriously undermine the fundamental policies underpinning those laws.

2. Respondent does not attempt to justify the court of appeals' far-reaching change in the federal securities laws: its holding—contrary to decisions of this Court and other circuits—that a subjective materiality standard applies to investors who have retained professional advisors. Instead, respondent states that the materiality of an omission depends on the total mix of information available—which is beside the point. Respondent does not address the consequences of the holding below, which would impair the ability of investors to obtain redress under the federal securities laws.

3. Respondent argues that this Court should defer to the factual conclusions of the court of appeals as a reasonable interpretation of the evidence. But under Fed. R. Civ. P. 52(a), the issue is not whether the court of appeals' conclusions reflected a permissible view of the evidence, but whether the *district* court's findings had evidentiary support. Indeed, respondent's argument confirms what the Petition demonstrated—that the court of appeals impermissibly substituted its own findings for amply supported findings of the district court.

ARGUMENT

I. RESPONDENT'S MISPLACED RELIANCE ON STATE LAW CANNOT AVOID THE SIGNIFICANT FEDERAL SECURITIES LAW ISSUE RAISED BY THE PETITION.

The court of appeals held that respondent's false representations could not give rise to liability under the federal securities laws because they involved reserves, *i.e.*, an estimation of future payments. App. at 44a. The court explained that a loss reserve liability is not subject to precise quantification "like a debt with fixed payments of principal and interest;" to estimate a reserve liability, "informed guesswork" is required. App. at 51a. Accordingly, the Second Circuit held that a reserve liability reflecting an estimate of future payments, even when falsely stated, is too soft a number on which to base liability under the federal statutes. *This* holding—contrary to the decisions of this Court and of other circuits—gives rise to the question of general applicability and profound public importance presented by the Petition. (*See* Petition at 10-16).

Rather than coming to grips with the substance of the Petition, respondent's principal contention is that the "Court of Appeals . . . resolved the primary issue presented for review under state contract law, not the federal securities laws." (Opp. Br. at 12). According to respondent, the Second Circuit held that respondent's false statements were not misrepresentations under state law; therefore, respondent asserts, the Second Circuit's decision is not properly reviewable by this Court.[2]

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2 Respondent's argument that "the Court of Appeals did not reach the reserve claim under the federal securities laws" (Opp. Br. at 14 n.14) is frivolous. The court of appeals reversed the district court as to *all* of Delta's claims, including those under the securities laws. Therefore, the court of appeals' discussion of respondent's misrepresentation of Elkhorn's net worth must apply not only to Delta's breach of warranty claim, but to its claims under the federal securities laws as well. (*See* Petition at 7 n.5).

Respondent's argument is unsound. *Federal*, not state, law controls what is and is not an actionable misrepresentation under the federal securities laws. *See Basic Inc. v. Levinson*, 485 U.S. 224, 244, n.22 (1988) ("Actions under Rule 10b-5 are distinct from common-law deceit and misrepresentation claims . . . and are in part designed to add to the protections provided investors by the common law"); *Herman & MacLean v. Huddleston*, 459 U.S. 375, 388-89 (1983) ("the antifraud provisions of the securities laws are not coextensive with common-law doctrines of fraud. Indeed, an important purpose of the federal securities statutes was to rectify perceived deficiencies in the available common-law protections by establishing higher standards of conduct . . . ") (footnote omitted).[3]

Respondent has no answer to Delta's showing that under *federal* law, the Second Circuit's holding is contrary to settled doctrine and, if not reviewed by this Court, will impede effective enforcement of the securities laws with respect to information of great importance to investors—corporate financial statements. Respondent does not contest the facts that the integrity of financial reporting by banks, insurance companies and other financial institutions depends on the accurate statement of reserve liabilities and that the court of appeals' decision would all but remove such critically important information from the purview of the federal securities laws. Instead, respondent relies on its spurious "state law" argument.

Contrary to respondent's argument, the decision below did not turn on the particular facts; its fulcrum was the Second Circuit's unprecedented and dangerous ruling that loss reserves in financial statements are necessarily the product of estimation or "guesswork" and therefore cannot be the basis of claims under § 12(2) or § 10(b). If the proper legal standards had been applied to the facts accepted by the Second Circuit, the district court's judgment could only have been

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3 *See also Brannan v. Eisenstein*, 804 F.2d 1041, 1046 (8th Cir. 1986) (federal courts applying the federal securities statutes are not bound by characterization of defendants as sellers under state law).

affirmed: As the court of appeals acknowledged, "Elkhorn was insolvent as of June 30, 1983" (App. at 44a), *i.e.*, Elkhorn's balance sheet showing a net worth of $18 million was *not* "complete and accurate in all material respects" and did *not* "present[ ] fairly the financial position of Elkhorn as at that date" as respondent had represented.[4] And, as the court of appeals acknowledged, the falsity of respondent's representation "could have been detected from information available as of that date." App. at 44a.[5] These facts alone—which the court of appeals *accepted*—should have mandated affirmance, because the finding that respondent reasonably could have known of the falsity of its representation stripped away respondent's only possible defense under § 12(2): that "in the exercise of reasonable care [it] could not have known, of [the] untruth or omission."[6] Yet rather than applying the statutory standard, the court of appeals reversed the district court on the ground that an understated reserve liability is merely a wrong guess about future events and hence not subject to scrutiny under the federal securities laws. In the absence of review by this Court, that holding would blunt the effective enforcement of the securities laws for the protection of the investing public.[7]

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4 In an example of doublespeak, respondent repeatedly asserts that its representations were "truthful." (Opp. Br. at 4, 13, 14, 18). If it is "truthful" to represent that a balance sheet showing a net worth of $18 million "fairly presents the financial position" of an insolvent company, it is hard to imagine what respondent would call false.

5 The court of appeals' acknowledgement that Elkhorn's understatement of reserves and insolvency "could have been detected from information *available as of that date*" (App. at 44a; emphasis added) puts to rest respondent's argument that Elkhorn's insolvency and gross understatement of reserves could be known only in light of hindsight. (Opp. Br. at 5, 13-14 & n.13).

6 Similarly, as set forth in the Petition, the district court's findings of fact which the Second Circuit did not find to be clearly erroneous establish that respondent met the "recklessness" scienter standard under § 10(b) adopted by virtually all other courts of appeals. (Petition at 8-9, 16-18, 22-23).

7 Respondent attempts to recast the issue as simply involving the reasonableness of Elkhorn's reserving procedures under GAAP. (Opp.

Respondent also suggests (Opp. Br. at 4, 5, 7-11, 14 & n.13, 17 n.18) that Delta was in as good a position as respondent to discover Elkhorn's true financial position. That, however, is legally irrelevant. Under the plain language of § 12(2) ("the purchaser not knowing of such untruth or omission"), a seller who misrepresents or omits a material fact is liable unless the purchaser has *actual* knowledge of the untruth or omission.[8] And neither of the courts below suggested that when Delta purchased Elkhorn's stock, it knew of Elkhorn's insolvency or gross understatement of reserves. Similarly, under § 10(b), liability attaches unless the plaintiff was reckless[9]—and neither of the courts below found Delta to have been reckless.

Br. at 4, 6, 13-14 & n.13, 18 & n.20). The issue, however, is not merely reasonableness under GAAP, but whether the Second Circuit correctly applied federal securities law when it held as a matter of law that there was no actionable misrepresentation or failure to disclose a material fact.

Similarly, respondent's argument (Opp. Br. at 5, 19) that the method of establishing reserves described in the Tillinghast reports was in the public domain is beside the point. The district court's judgment was not based on respondent's failure to disclose methods of calculating reserves, but on its failure to disclose the information in those reports which revealed Elkhorn's enormous understatement of its reserve liability.

8 *See Wright v. National Warranty Co., L.P.*, 953 F.2d 256, 262 (6th Cir. 1992) ("the statute bars recovery only when a plaintiff has actual knowledge that a representation is false or knows that existing information has been withheld"); *MidAmerica Federal Savings and Loan Ass'n v. Shearson/American Express, Inc.*, 886 F.2d 1249, 1256-57 (10th Cir. 1989) ("A purchaser has no duty to investigate a seller's possible fraud and need not verify a statement's accuracy. . . . [T]he plain meaning of . . . section 12(2) . . . requires only that purchasers of securities show a lack of actual knowledge . . . in order to prevail"); *Casella v. Webb*, 883 F.2d 805, 809 (9th Cir. 1989) ("Constructive knowledge cannot bar a purchaser's recovery under section 12(2). . . . [P]urchasers may recover unless they have actual knowledge of the untruth or omission").

9 *Wright*, 953 F.2d at 261 ("A recklessness standard is to be used in determining whether the plaintiff justifiably relied on a misrepresentation or omission"); *Molecular Technology Corp. v. Valentine*, 925

As explained above, the facts that *were* found by the district court (and not found clearly erroneous on appeal) would have resulted in affirmance, were it not for the court of appeals' mistaken rule of law—a rule which would do untold mischief to the effective enforcement of the securities laws and accordingly merits review by this Court.

II. RESPONDENT FAILS TO JUSTIFY THE COURT OF APPEALS' FAR-REACHING CHANGE IN THE MATERIALITY STANDARD UNDER THE SECURITIES LAWS.

In overturning the district court's finding as to the materiality of the actuarial reports concealed from Delta by respondent, the Second Circuit held that a subjective materiality standard applies when the investor has employed professional advisors, rather than the objective standard of what would be significant to a reasonable investor. (Petition at 18-20).[10] Respondent counters with the irrelevant observation that materiality is determined on a case by case basis depending on the total mix of information available. (Opp. Br. at 15-16). While materiality may depend on the total mix of information available, the question of materiality remains "an objective one, involving the significance of an omitted or misrepresented fact *to a reasonable investor.*" *TSC Industries, Inc. v. Northway, Inc.*, 426 U.S. 438, 445 (1976) (emphasis added). There is "no authority . . . for varying

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F.2d 910, 918 (6th Cir. 1991); *Royal American Managers, Inc. v. IRC Holding Corp.*, 885 F.2d 1011, 1016 (2d Cir. 1989) ("a plaintiff bears only the burden of negating its own 'recklessness,' once the issue of diligence is raised by defendant"); *Dupuy v. Dupuy*, 551 F.2d 1005, 1020 (5th Cir.), *cert. denied*, 434 U.S. 911 (1977).

10 Respondent states that Tillinghast "did not express an opinion on the adequacy of the reserves." (Opp. Br. at 7.) What respondent neglects to mention is that respondent instructed Tillinghast not to calculate the reserves. App. at 61a. The district court found that respondent's reason for so instructing Tillinghast was that respondent knew such a calculation "would record that Elkhorn's loss reserves were seriously understated." *Id.*

the standard of materiality depending on who brings the action . . . ." *Basic Inc. v. Levinson*, 485 U.S. 224, 240 n.18 (1988).[11]

As set forth in the Petition, the court of appeals' holding that materiality turns on the subjective interests of the investor's particular advisors is at odds with the decisions of this Court and other courts of appeals and would seriously undermine the applicability of the federal securities laws to securities transactions in which the investor has retained advisors.[12]

III. RESPONDENT FAILS TO REBUT DELTA'S SHOWING THAT THE SECOND CIRCUIT VIOLATED THE MANDATE OF FED. R. CIV. P. 52

As set forth in the Petition, the Second Circuit violated Fed. R. Civ. P. 52(a)'s mandate that findings of the district court not be set aside unless "clearly erroneous." (Petition at 21-25). Respondent's brief, far from rebutting Delta's showing, actually supports its position.

Respondent *concedes* that reasonable judges may differ as to the inferences to be drawn from the record evidence in this case: "[A]nother reviewing panel might 'find the record

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11 All but one of the cases cited by respondent held that materiality is determined by the *objective* standard of what would be significant to a reasonable investor, not by the subjective standard of what would be of interest to the particular investor. *Basic Inc. v. Levinson*, 485 U.S. at 231-32; *TSC Industries, Inc. v. Northway, Inc.*, 426 U.S. at 445, 449; *Kademian v. Ladish Co.*, 792 F.2d 614, 623 (7th Cir. 1986); *Michaels v. Michaels*, 767 F.2d 1185, 1196 & n.3 (7th Cir. 1985), *cert. denied*, 474 U.S. 1057 (1986). *Titan Group, Inc. v. Faggen*, 513 F.2d 234 (2d Cir.), *cert. denied*, 423 U.S. 840 (1975), cited by respondent, is inconsistent with this Court's subsequent decision in *TSC Industries*.

12 As set forth in the Petition (pp. 20-21), the Second Circuit's materiality standard was legally deficient in another respect as well: The court of appeals concluded that the Tillinghast reports were not material because they "would not have changed events," App. at 38a, in conflict with the decisions of this Court that information need not be outcome-determinative to be material. Finding no way to justify the Second Circuit's departure from this Court's decisions, respondent simply ignores the issue.

tilting one way rather than the other, though fair-minded judges could find it tilting either way' . . . ." (Opp. Br. at 18, quoting *NLRB v. Pittsburgh Steamship Co.*, 340 U.S. 498, 503 (1951)). If respondent is correct that reasonable judges may differ, then by definition the Second Circuit usurped the trial court's function by substituting its own findings for those of the district court. As this Court has declared, Rule 52(a)

> plainly does not entitle a reviewing court to reverse the finding of the trier of fact simply because it is convinced that it would have decided the case differently. The reviewing court oversteps the bounds of its duty under Rule 52(a) if it undertakes to duplicate the role of the lower court. . . . If the district court's account of the evidence is plausible in light of the record viewed in its entirety, the court of appeals may not reverse it even though convinced that had it been sitting as the trier of fact, it would have weighed the evidence differently. *Where there are two permissible views of the evidence, the factfinder's choice between them cannot be clearly erroneous.*

Anderson v. Bessemer City, 470 U.S. 564, 573-74 (1985) (emphasis added).

Respondent does not even attempt to show that the district court's findings were not a "permissible view[ ] of the evidence." Instead, it attempts to reargue the facts. But the proper place for that was in the district court. This Court should grant review pursuant to its supervisory power over the federal judicial system to correct the court of appeals' extreme departure from the bedrock principle of federal appellate review—Rule 52(a)'s mandate of deference to the factual findings of the trial court.

CONCLUSION

For the reasons stated above and in the Petition, the Court should grant a writ of certiorari in this case.

Dated: April 8, 1992

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